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Legal Report to

The Blue Ribbon Commission on

Public Employees Retirement Systems of

Kentucky

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A. BACKGROUND

1. Executive Order

On April 4, 2007, Governor Fletcher issued Executive Order 2007-282, establishing the Blue Ribbon Commission on Public Employees Retirement Systems – the Kentucky Employees Retirement System (KERS), the State Police Retirement System (SPRS), the County Employees Retirement System (CERS), and the Kentucky Teachers' Retirement System (KTRS).

Praising them all as excellent programs that had provided benefits to retirees and promise of the same for future retirees – his order highlighted two problems:

1) Increasing medical costs and market changes that have substantially increased the costs of the long-term obligations of the retirement programs; and

2) Actuarial reports in 2006 that demonstrated a significant increase in the Unfunded Actuarial Accrued Liability of all four systems due to the new accounting methods required by Governmental Accounting Standards Boards (GASB) finalized in 2004. That liability now that GASB rules 43 and 45 have been adopted, is stated at approximately $28.4 billion as of June 30, 2007, divided among the four systems as follows:

System	UAAL Amount (in millions)
KERS	11,294*
CERS	6,857*
SPRS	649
KTRS	9,677

*Combines H and NH amounts.

2. Commission's Charge

The Governor's Executive Order asserted 1) the Commonwealth's obligation to honor the inviolable contracts with current retirees and employees participating in the four systems; and 2) the need to ensure that Kentucky state government, municipalities, local school districts and other affected entities remain solvent while attempting to offer competitive retirement benefits in the future.

The Executive Order directed the Blue Ribbon Commission to study methods to address the current unfunded liabilities of the Commonwealth's retirement systems so as to fulfill the promises to current retirees and employees and to ensure appropriate levels of benefits for future employees, and to deliver its recommendations on issues and policies to the Governor, the State Government Committee, and the Appropriations and Revenue Committees of the Kentucky General Assembly, not later than December 1, 2007.

3. Commission's Charge to Consultants

The Commission was given authority to hire outside legal and actuarial consultants. After circulating a request for proposals, the Secretary of the Finance and Administration Cabinet has contracted with Morrison & Foerster LLP to provide legal and consulting services to the Commission, and specifically to consult with the Commission regarding constitutional and statutory issues relating to the matters the Commission will study, including but not limited to, the concept of the "inviolable contract." Morrison & Foerster also will be asked to provide assistance with the formation, development and presentation of recommendations, including legislative proposals, which may be adopted or presented by the Commission detailing its conclusions and recommendations. Morrison & Foerster, not admitted to practice in Kentucky, has associated Kentucky counsel, Greenebaum Doll & McDonald PLLC to assist Morrison & Foerster in performing these services.

Initially, the Commission has asked for a review of the law governing the concept of the "inviolable contract," generally and with respect to the members of KERS, CERS, SPRS, and KTRS, including both pension benefits and medical benefits.

B. KENTUCKY PUBLIC EMPLOYEES RETIREMENT SYSTEMS

This section summarizes the statutory structure of the four systems.

1. Kentucky Employees Retirement System (KERS)

The General Assembly established KERS (KRS 61.510 through 61.705) in 1956 to provide pension benefits and medical coverage to retired or disabled state government employees and their beneficiaries. KRS 61.515. KERS is administered by the Board of Trustees of the Kentucky Retirement Systems ("Board"). KRS 61.645.

a. Pension Benefits

For retired or disabled members, KERS provides for either a retirement allowance or a disability allowance. KRS 61.595 and 61.605. The pension benefits offered under KERS are funded through both employee and employer contributions. All contributions are held in the Kentucky Employee Retirement Fund created by KRS 61.515. KRS 61.570 provides, "All of the assets of the system shall be held and invested in the Kentucky employees retirement fund and credited, according to the purpose for which they are held, to one (1) of two (2) accounts, namely, the member's contribution account, and the retirement allowance account." The earnings on those contributions make up approximately 64% of the funds available for benefits.

Employee contributions (including those picked up by the employer under KRS 61.560) are made for each pay period at a rate of 5% of a member's creditable compensation and are contributed to the Retirement Fund.

Employer contributions rules for KERS are generally set forth in KRS 61.565. There are two components to the mandatory employer contributions required under KRS 61.565:

- ***"Normal Contributions"*** – a percent of creditable compensation determined by the entry age normal cost funding method; "normal cost" is the level percentage of payroll contribution (from entry age to retirement) required to accumulate sufficient assets at retirement to pay for the employee's projected retirement benefit; and

- ***"Past Service Contributions"*** – a percent of creditable compensation computed by amortizing the total unfunded past service liability over a 30 year period, calculated using the level-percentage-of-payroll amortization method. (KRS 61.510(28) defines "level-percentage-of-payroll amortization method" to mean the method of determining the annual amortization payment on the unfunded past service liability as expressed as a percentage of payroll over a set period of years. Under this method, the percentage of payroll shall be projected to remain constant for all years remaining in the set period and the unfunded past service liability shall be projected to be fully amortized at the conclusion of the set period.)

KRS 61.565 provides that the contribution rates will be based "on actuarial bases adopted by the Board."

A special law enacted by the General Assembly established employer contribution rates for June 1, 2004 through July 30, 2006. 2004 (1st Extra. Sess.) Ky. Acts Ch. 1 Section 9 provides that the employer contribution rates, expressed as a percentage of creditable compensation, are as follows:

- Nonhazardous Duty Employees – 5.89%; and

- Hazardous Duty Employees – 18.84%.

KRS 61.670(1) requires the Board to adopt actuarial tables necessary for the administration of KERS and for the annual determination of its assets and liabilities. The Board is required to cause an annual actuarial valuation, including a description of the actuarial assumptions used. At least once in each ten year period, the Board is to cause an actuarial investigation to be made of the experience of KERS. *Id*. Pursuant to this investigation, the Board may revise the actuarial tables it previously adopted. *Id*. With respect to the ten year investigation, the Board is required to submit a copy of the report to the Kentucky Legislative Research Commission, which is instructed to retain its own actuary to review the findings of the report. KRS 61.670(2) and (3). The actuarial services (which the Board may contract under KRS 61.645(2)(d)) shall be certified by a fellow of the Society of Actuarials. KRS 61.670(1).

KRS 61.692 provides:

> It is hereby declared that in consideration of the contributions by the members and in further consideration of benefits received by the state from the member's employment, KRS 61.510 to 61.705 shall, except as provided in KRS 6.696 effective September 16, 1993, constitute an **inviolable contract of the Commonwealth**, and the benefits provided therein shall, except as provided in KRS

> 6.696, not be subject to reduction or impairment by alteration, amendment, or repeal. (Emphasis added.)

b. Medical Benefits

KERS provides medical benefits to retirees participating in the three plans under KRS 61.701 and 61.702. The medical benefits are funded through a separate fund, the Kentucky Retirement Systems Insurance Fund ("Insurance Fund"), KRS 701, which the Board also administers. The Insurance Fund is used to pay premiums for medical benefits for recent and future recipients of a retirement allowance from any of the three systems — except for those hired after July 1, 2003, whose eligibility and rights are specially covered by KRS 61.702(8).

KRS 61.702(2) specifically provides that each employer participating in KERS shall contribute to the Insurance Fund an employer contribution at a set rate of creditable compensation. KRS 61.702(2) states, "Such employer contribution rate shall be developed by appropriate actuarial method as a part of the determination of each respective employer contribution rate to each respective retirement system determined under KRS 61.565."

There are complex provisions describing how premiums for hospital and medical benefits will be paid "wholly or partly" from recipients on the Insurance Fund. KRS 61.702(3) – (7).

KRS 61.701 and 61.702 are specifically included by KRS 61.692 as part of the "inviolable contract" of the Commonwealth – with one exception – KRS 61.702(8)(d), which specifically excludes post-June 30, 2003 new hires:

> The benefits of this subsection provided to a member whose participation begins on or after July 1, 2003, shall not be considered as benefits protected by the inviolable contract provisions of KRS 61.692…. The General Assembly reserves the right to suspend or reduce the benefits conferred in this subsection if in its judgment the welfare of the Commonwealth so demands.

That section was enacted into law as 2003 KY. Acts Chapter 155, § 1; 2004 KY. Acts Chapter 33 and 2004 KY. Acts 36.

2. State Police Retirement System (SPRS)

In 1958, the General Assembly established SPRS (KRS 16.505 through 16.652) to provide retirement or disability benefits and medical benefits for all regular full-time members of the Kentucky State Police and certain beneficiaries. KRS 16.510 and 16.520. The Board administers SPRS. KRS 16.640.

a. Pension Benefits

SPRS provides for a retirement allowance or a disability retirement allowance to retired or disabled SPRS members. KRS 16.576 and 16.582. The pension benefits are funded by both employee and employer contributions. KRS 16.545(2) provides that the member contribute for each pay period 8% of creditable compensation. KRS 16.645(19) provides that KRS 61.565 also

applies with respect to determining the amount of employer contributions to fund SPRS benefits. Accordingly the rules set forth above regarding the determination of employer contributions for KERS pension benefits also apply to SPRS pension benefits. There is a special rule established by the General Assembly regarding the employer contribution rate for July 1, 2004 through June 30, 2006. 2004 (1st Extra. Sess.) Ky. Acts Ch. 1 Section 9 provides that the employer contribution rate for SPRS, expressed as a percentage of creditable compensation, is 21.58%.

KRS 16.652 provides:

> It is hereby declared that in consideration of the contributions by the member, and in further consideration of benefits received by the state from the member's employment, KRS 16.510 to 16.645, except as provided in KRS 6.696 effective September 16, 1993, shall constitute **an inviolable contract of the Commonwealth**, and the benefits provided therein shall, except as provided in KRS 6.696, not be subject to reduction or impairment by alteration, amendment or repeal.

b. Medical Benefits

Present and future recipients of a retirement allowance from SPRS also are entitled to medical benefits under the provisions of KERS. KRS 16.645(23) and 61.702(1)(a). Accordingly, the Insurance Fund, administered by the Board, is used to provide medical insurance to SPRS members. KRS 61.701(2). KRS 61.702(2) requires each employer participating in SPRS to contribute to the Insurance Fund an employer contribution at a rate developed by an appropriate actuarial method as part of the determination of the employer contribution rate set under KRS 61.656.

KRS 61.702(8)(d) specifically provides:

> The benefits of this subsection provided to a member whose participation begins on or after July 1, 2003, shall not be considered as benefits protected by the individual contract provisions of KRS 61.692 [KERS members], 16.652 [SPRS members], and 78.852 [CERS members]. The General Assembly reserves the right to suspend or reduce the benefits conferred in this subsection if in its judgment the welfare of the Commonwealth so demands.

Accordingly, with respect to the medical benefits of SPRS members whose participation began on or after July 1, 2003, such benefits do not constitute an "inviolable contract" of the Commonwealth under KRS 16.652.

3. County Employees Retirement System (CERS)

The General Assembly established CERS (KRS 78.510 through KRS 78.852) in 1958, for the benefit of eligible employees of Kentucky counties and certain other political subdivisions. Along with KERS and SPRS, the Board administers CERS. KRS 78.780.

a. Pension Benefits

CERS provides a retirement allowance or disability retirement allowance to eligible CERS members. KRS 78.545(11) and (14), and 61.702(1)(a). For the calculation of the retirement allowance, CERS refers to KRS 61.595. KRS 78.545(14). For the determination of the disability retirement allowance, CERS refers to KRS 61.605. KRS 78.545(11). KRS 78.545(34) provides that employer contributions will be determined under KRS 61.565. Accordingly, as with respect to employer contributions under SPRS, the determination of employer contributions under CERS follows the rules set forth for KERS. KRS 78.610 also provides for employee contributions in an amount equal to 5% of creditable compensation for each pay period.

KRS 78.852 similarly provides,

> It is hereby declared that in consideration of the contributions by the members and in further consideration of benefits received by the county from the member's employment, KRS 78.510 through 78.852 shall, except as provided in KRS 6.696, constitute **an inviolable contract of the Commonwealth**, and the benefits provided therein shall, except as provided in KRS 6.696, not be subject to reduction or impairment by alteration, amendment or repeal.

b. Medical Benefits

CERS also provides medical insurance benefits to present and future recipients of a retirement allowance from certain beneficiaries, referring to KERS and KRS 61.702. KRS 78.545(36). Accordingly, the Insurance Fund, administered by the Board, is used to provide medical insurance to retired or disabled CERS members. KRS 61.701(2). KRS 61.702(2) requires each CERS employer to contribute to the Insurance Fund an employer contribution at a rate developed by an appropriate actuarial method as part of the determination of the employer contribution rate set under [KRS 61.565.]

Again, although the general inviolable contract provision of 61.692 applies to the medical benefits of CERS members, KRS 61.702(8)(d) specifically provides, "The benefits of this subsection provided to a member whose participation begins on or after July 1, 2003, shall not be considered as benefits protected by the inviolable contract provisions of KRS 61.692 [KERS members], 16.652 [SPRS members], and 78.852 [CERS members]. The General Assembly reserves the right to suspend or reduce the benefits conferred in this subsection if in its judgment the welfare of the Commonwealth so demands."

Accordingly, with respect to the medical benefits of CERS members whose participation began on or after July 1, 2003, such benefits do not constitute an "inviolable contract" of the Commonwealth.

4. Kentucky Teachers Retirement System (KTRS)

The General Assembly enacted legislation in 1938 that created KTRS (KRS 161.220 through 161.716, and 161.990) effective July 1, 1940. KRS 161.230. KTRS provides a retirement allowance and medical insurance for retired (or disabled) teachers and certain beneficiaries. KTRS is administered separately from KERS, SPRS and CERS by the Board of Trustees of the Teachers' Retirement System of the State of Kentucky ("Teachers Board"). KRS 161.250.

a. Pension Benefits

KTRS provides eligible members, as well as certain beneficiaries and surviving spouses, with a retirement allowance or disability retirement allowance upon retirement or disability. KRS 161.620 and 161.661. The pension benefits are funded through both employee and employer contributions. KRS 161.540 requires that teachers who are non-university faculty members make a contribution equal to 9.855% of annual compensation. University faculty members are required to make a contribution equal to 8.375% of annual compensation. However, KRS 161.565 permits universities to pick up 2.215 percentage points of this employee contribution. Such employee contributions are to be made no more than 15 days following the end of each payroll period. KRS 161.560(1). KRS 161.550 provides that each employer participating in KTRS must make an annual contribution to KTRS in an amount equal to the employee contribution plus an additional 3.25% of the total of salaries of KTRS members it employs. KRS 161.550(1). In addition, KRS 161.550(3) requires the state to fund any ad hoc cost-of-living increases that it may approve, which are to be amortized over twenty years according to the funding schedule set forth in KRS 161.553. KRS 161.400 instructs the Teachers Board to designate an actuary to advise the Teacher Board, to make an annual valuation of KTRS assets and liabilities, and to make an actuarial investigation of the experience of KTRS at least every six years. The results of the actuarial investigation are to be submitted to the Kentucky Legislative Research Commission. KRS 161.400(3).

KRS 161.714 provides:

> It is hereby declared that in consideration of the contributions by members and in further consideration of benefits received by the state from the member's employment, KRS 161.220 to 161.710 shall constitute, except as provided in KRS 6.696, **an inviolable contract of the Commonwealth**, and the benefits provided herein shall, except as provided in KRS 6.696, not be subject to reduction or impairment by alteration, amendment, or repeal.

b. Medical Benefits

Under KRS 161.675, KTRS also provides medical benefits to eligible members, and certain beneficiaries and surviving spouses. Medical benefits are paid for both by premium charges from members and spouses and by amounts from the KTRS medical insurance fund. KRS 161.675(3). KRS 161.550 provides that the state shall contribute annually to KTRS a percentage of the total salaries of the state-funded and federally-funded members it employs to

provide stabilization funding for the medical insurance fund. KRS 161.550 states, "The percentage to be contributed by the state shall be determined by the retirement system's actuary for each biennial budget period. The percentage to be contributed by the state may be suspended or adjusted by the General Assembly if in its judgment the welfare of the Commonwealth so demands." The medical benefits furnished under KRS 161.675 are incorporated by reference within the "inviolable contract" provisions of KRS 161.714. However, the levels of coverage and eligibility conditions may be changed to meet the changing needs of the annuitants and when necessary to contain the expenses of the insurance program within the funds available to finance the program. KRS 161.675(2).

5. Health Care Insurance Coverage For State Employees

KRS 18A.225 concerns health care insurance coverage for state employees. As used in this statute, the term "employee" includes, among others,

> Any person who is a present or future recipient of a retirement allowance from the Kentucky Retirement Systems, Kentucky Teachers' Retirement System, the Legislators' Retirement Plan, the Judicial Retirement Plan, or the Kentucky Community and Technical College System's optional retirement plan authorized by KRS 161.567, except that a person who is receiving a retirement allowance and who is age sixty-five (65) or older shall not be included, with the exception of persons covered under KRS 61.702(4)(c), unless he or she is actively employed pursuant to subparagraph 1. of this paragraph. KRS 18A.225(1)(a)(4).

The statute provides in part,

> Health insurance coverage provided to state employees under this section shall, at a minimum, contain the same benefits as provided under Kentucky Kare Standard as of January 1, 1994. KRS 18A.225(2)(a).

Chapter 18A is entitled "State Personnel." Sections 18A.225 et seq., "Health Coverage," do not incorporate by cross-reference the "inviolable contract" provisions as do the other chapters that delineate the retirement systems. Nevertheless its broad definition of "employee" appears to include most state employees who are members of the various retirement systems and who are parties to that clause.

Litigation has been pending since 1998 to decide whether KRS 18A.225 imposes a minimum standard of health insurance benefit on members of those systems who fall within the definition of employee in KRS 18A.225(1)(a)(1-4), and who claim entitlement to health plan coverage under KRS 61.702.

6. ERISA and PBGC Inapplicable

Employee benefit plans (both pension and welfare benefit plans) are generally subject to federal regulation, which largely preempts state or local regulation. Federal employee benefits

laws, however, largely do not apply to the retirement programs administered by the Kentucky Retirement Systems.

Over thirty years ago, Congress enacted the Employee Retirement Income Security Act of 1974 ("ERISA") Public Law No. 93-406, 88 Statutes at Large 829 (1974) (codified at 29 U.S.C. § 1000, *et seq*.), which has been subsequently amended from time to time. Title I of ERISA sets forth a comprehensive regulatory scheme for the nation's private employee benefit plans, with rules regarding disclosure, reporting, record retention, coverage, accrual requirements, distribution, funding, fiduciary duties, and continuation coverage, as well as civil and criminal enforcement mechanisms. Section 4(b)(1) of ERISA (29 U.S.C. § 1002(b)(1)), however, specifically provides that Title I of ERISA does not apply to "governmental plans." Section 3(32) of ERISA (29 U.S.C. § 1001(32)) specifically defines "governmental plan" to include a plan maintained for its employees by "the government of any State or political subdivision thereof." Accordingly, Title I of ERISA does not apply to KERS, SPRS, CERS or KTRS.

Title IV of ERISA (29 U.S.C. § 1301, *et seq*.) creates and sets forth rules regarding the Pension Benefit Guaranty Corporation ("PBGC"), which insures the applicable portion of pension benefits of participants and beneficiaries in most private defined benefit plans. The PBGC, however, does not insure any benefits under KERS, SPRS, CERS, or KTRS. Section 4021(b)(2) of ERISA (29 U.S.C. § 1321(b)(2)) specifically excludes from PBGC coverage any plan established and maintained for its employees by the government of any State or political subdivision thereof, or any agency or instrumentality thereof.

C. THE "INVIOLABLE CONTRACT"

This section describes the source and use of that term in American and Kentucky law.

The genesis of the term "inviolable contract" appears in early American decisions, largely related to contracts between a governmental agency and a public utility or a financial institution in which the private agency, chartered or regulated by the government, obtained a right that either the government or the private entity later claimed could not be changed.

The cases have gone both ways – sometimes enforcing inviolability, sometimes not, and sometimes for or against the claimant. See, for example (emphasis everywhere added):

St. Cloud Public Service Co. v. St. Cloud, 265 U.S. 352, 355 (1924), where a gas company argued that the rate fixed by contract was inadequate, confiscatory, and deprived it of its property without due process of law. The court affirmed the district court's dismissal of the gas company's action. The contract was binding on both parties alike, such that the city could not lower the rate and the gas company could not raise the rate.

It has been long settled that a State may authorize a municipal corporation to establish by an **inviolable contract** the rates to be charged by a public service corporation for a definite term, not grossly unreasonable in time, and that the effect of such a contract is to suspend, during its life, the governmental power of fixing and regulating the rates. *Home Telephone Co. v. Los Angeles*, 211 U.S. 265, 273, and cases there cited.

Home Tel. & Tel. Co. v. Los Angeles, 211 U.S. 265, 273 (1908):

"It has been settled by this court that the State may authorize one of its municipal corporations to establish by an **inviolable contract** the rates to be charged by a public service corporation (or natural person) for a definite term, not grossly unreasonable in point of time, and that the effect of such a contract is to suspend, during the life of the contract, the governmental power of fixing and regulating the rates. *Detroit v. Detroit Citizens' St. Ry. Co.*, 184 U.S. 368, 382; *Vicksburg v. Vicksburg Water Works Co.*, 206 U.S. 496, 508."

St. Louis v. United R. Co. 210 U.S. 266, 279-280 (1908): "because a street railway company has agreed to pay for the use of the streets of the city for a given period, it does not thereby create an **inviolable contract** which will prevent the exaction of a license tax under an acknowledged power of the city, unless this right has been specifically surrendered in terms which admit of no other reasonable interpretation."

Bank of Kentucky v. Kentucky, 207 U.S. 258, 262 (1908), rejecting bank's effort to avoid taxes by claiming "that the Bank of Kentucky was only taxable under a law of the State, called the Hewitt law, and that such law constituted an **inviolable contract** between the bank and the State."

Blair v. Chicago, 201 U.S. 400, 453 (1906), rejecting claim that streetcar companies' franchises from the state to develop and operate streetcars on the streets of the city through an 1859 act, and that "this broad right is derived from the public act of the state legislature, which, upon its acceptance, has become an **inviolable contract** between the State and the companies."

Deposit Bank v. Frankfort, 191 U.S. 499, 508 (1903): "At one time it was held by the Court of Appeals of Kentucky that its provisions, [of the Hewitt law,] when complied with by the bank seeking to avail itself of its privileges, constituted a valid and binding contract." *Commonwealth, use of Franklin Co. v. Farmers' Bank of Kentucky et al.*, 97 Kentucky, 590. In a later case the Court of Appeals of Kentucky held the law not to constitute an **inviolable contract**. *Deposit Bank of Owensboro v. Daviess Co.*, 102 Kentucky, 174. When the law was before this court, the same conclusion was reached. *Citizens' Savings Bank of Owensboro v. Owensboro*, 173 U.S. 636.

Subsequent cases involving local pension funds of cities in Kentucky have utilized the term to resolve claims in the '40s, prior to the time the Kentucky Employees Retirement System was enacted in 1956. *See, e.g.* (emphasis everywhere added):

Henderson et al. v. Thomy et al., 307 Ky. 783, 785 212 S.W.2d 303 (1948), upholding against attack as unconstitutional a civil service statute that stated in part:

> (3) When any city of the third class adopts an ordinance under this section for the creation of a pension fund and accepts from its employees a portion of their wages and levies a tax therefor, an **inviolable contract** shall be created between the city as employer and its employees, and the city and its employees shall continue to operate under KRS 90.310 to 90.410 and the adopting ordinance.

> A repeal of that ordinance by the city shall in no wise affect such employees.

Elliott v. City of Covington, 304 Ky. 802, 805, 202 S.W.2d 621, 622 (1947) referring to the same statute as creating an inviolable contract, but rejecting the claim of an employee who was hired in 1940 by the city manager perfunctorily and without examination to work in the city's water department, whose wages were used to pay into the city's pension fund the monthly amounts required under a city ordinance plan for civil service employment, and who worked until 1944, when he was dismissed arbitrarily without preferment of any charge against him. *Held*, the employee did not acquire civil service status so as to prevent his arbitrary dismissal from service thereafter simply by working and making pension plan wage payments by way of salary deductions.

Owensboro v. Board of Trustees, City of Owensboro Employees Pension Fund, et al., 301 Ky. 113, 119, 190 S.W.2d 1005, 1008 (1945), where the court held that there was no authority conferred upon the city's officers after the repeal of the civil service ordinance to place anyone under civil service. The court found that the trustees and the employees could possibly have no vested rights as under a civil service ordinance (and its pension fund) which was nonexistent. The court held that the trial court correctly declared the city's rights.

D. KENTUCKY CASE LAW AND OTHER RELEVANT OPINIONS.

This section describes the evolution of Kentucky public pension law.

1. Traditional Pension Cases in Kentucky.

Kentucky courts traditionally had found that pensioners had no vested right to their pensions. For example, in *Head v. Jacobs,* 150 S.W.2d 349 (Ky. 1912), the Court upheld a determination of the local board of pensions that declined to transfer certain pensioners and beneficiaries to a newly created pension roll. In 1904, legislative provision was made for pensions for policemen in cities of the first class. In 1912, the General Assembly repealed the 1904 Act and enacted another pension program. The 1912 Act provided as follows:

> All pensions that are now in force under the law heretofore, existing are declared to be hereby ended and abolished: Provided, that all pensions and beneficiaries under the laws hereby abolished shall be continued as such by the board duly organized under this act, if, under the terms of this act, they would be entitled to apply for and receive pensions, or benefits, and said transferred pensioners and beneficiaries shall be subject to all the rates and provisions of this act in the same manner as if their claims had been originally allowed under the same.

Id., at 350. The board of pensions declined to transfer certain pensioners who were entitled to pensions under the 1904 Act but who were not entitled to pensions under the 1912 Act. *Id.* The Court stated, "A pensioner has no vested right to his pension." *Id.* The Court continued, "The Legislature which created it can recall its bounty at its discretion." *Id.* Strictly applying the terms of the 1912 Act, the Court upheld the determination of the board of pensions.

Indeed, one case indicated a willingness to defer to the discretion of the board of trustees of a municipal pension plan even in the case of fraud. In *Rohe v. City of Covington*, 73 S.W.2d 19 (Ky. 1934), the Court found that, pursuant to the terms of the statute, the Court did not have jurisdiction to order the board of trustees of the police and firemen's pension fund to grant a pension upon allegations of fraud in refusing the application because the statute declared the decision of the board of trustees to be final and conclusive. The Court reasoned as follows:

> Indeed the granting of a pension in the first instance does not stand on the plane of a contract right or right vested by statute. A pension is a bounty springing from the appreciation and graciousness of the sovereign, and may be given or withheld at its pleasure. [Citation omitted.] It is for the Legislature to say what classes of persons shall receive pensions, and to fix the terms and conditions on which they will be granted. Statutes creating a pension fund for policemen and firemen usually place in the hands of the pension board created to manage and control the fund the power to determine who shall be entitled to the pension benefits and to make action in such matters final and conclusive. As a provision to that effect is well within the legislative power, the remedy is exclusive, and the civil courts are without jurisdiction to review the judgment of the board.

Id. at 20. The Court concluded, "Being without jurisdiction, we cannot review the facts, even though the members of the board arbitrarily, unlawfully, and in fraud of plaintiff's rights, and contrary to the provisions of law and facts presented to them, rejected plaintiff's claim." *Id.*

Miller v. Price, 139 S.W.2d 450 (Ky. 1940) held that a fireman had no vested rights to a pension fund, even though the fund was partially funded by involuntary assessments on the monthly salary of each fireman. This case was one of the first to address whether a denial of pension benefits by a board of trustees could run afoul of the due process provisions of either the Kentucky or United States Constitutions. In *Miller*, the plaintiff had worked as a fireman in Lexington for almost 20 years prior to his retirement due to disability. The plaintiff filed an application with the board of trustees of the Lexington police and firemen's pension fund asking to be placed on the pension roster. The board of trustees rejected his application. *Id.* The plaintiff asserted that the pension fund partially was funded by a one per centum assessment on each fireman, thereby giving him a vested right in the pension fund which could not be deprived without due process of law, and that the pension was not a gratuity or bounty of the state. *Id.* at 452. Following a number of prior cases from other jurisdictions, the Court stated, "If this reasoning be sound, then it should inevitably follow that one whose name had not been placed on the retired list would in no event have acquired any vested rights." *Id.* at 453. The Court disagreed that the fact that a pensioner had made compulsory contributions to a pension fund did not vest the pensioner with rights in the fund. *Id.* Accordingly, the Court concluded that the denial of pension benefits would not run afoul of the due process provisions of either the Kentucky or United States Constitutions. *Id.* at 454. Thus, in Kentucky's early pension jurisprudence, public pensions tended to be treated as "bounties" or "gratuities," that the General Assembly or local municipality could revoke at will - even where employee contributions were

compulsory. Indeed, in the face of statutes deferring to local boards, courts proved reluctant to intervene to uphold a pensioner's rights.

2. From "Gratuity" to Deferred "Compensation" - Contractual Rights.

The jurisprudence gradually shifted, as pensions began more to be viewed as deferred compensation. In *Talbott v. Thomas*, 151 S.W.2d 1 (Ky. 1941), the Court held that a law providing for the payment of $5,000 per year to retired judges was in violation of the Kentucky constitution. The Court treated retirement benefits for judges as "compensation" subject to the limitations of then section 246 of the Kentucky Constitution. In 1940, the General Assembly enacted legislation under which retiring judges from the Kentucky Court of Appeals would be entitled, under certain circumstances, to a pension of $5,000 per year, either for a period of years or for life. *Id.* at 2. Section 246 of the then Kentucky Constitution provided that no public officer of the Commonwealth, except the Governor, would receive more than $5,000 per annum for official services. The judges on the Court of Appeals already were receiving $5,000 per year as salary compensation. Because the Commissioner of Finance hesitated to make provision for the payment of amounts under a potentially unconstitutional statute, the judges filed suit to require the Commissioner to execute the law. While expressing some sympathy for the hard work and poor compensation of the judges, the special Court of Appeals reasoned as follows:

> The regular salary of each judge of the Court of Appeals is, and has been for many years, $5000 per annum. The retirement pay provided by the Act of 1940 constitutes emoluments over and above the salary of $5000 per annum. The words "per annum" in section 246, limiting compensation for official services to $5000 per annum, evidently refer to the period during which the services were rendered, and not to the time of payment. The object was to limit the amount of compensation for a year's service.

Id. 3-4. Finding the 1940 Act unconstitutional, the Court stated, "It is clear that the amounts authorized by this act to be paid the judges after their retirement is intended as additional compensation for the official services rendered by them." *Id.* at 4. The Court rejected arguments that compensating a person for many years of service should be distinguished from compensating a person for one year of service. *Id.* at 5. The Court also rejected arguments that the judges ought to be compensated for having given up their private legal practices. *Id.*

In *Board of Education of Louisville v. City of Louisville*, 157 S.W.2d 337 (Ky. 1941), the Court treated the vested rights of pensioners under a local pension plan for teachers as contractual rights, holding that the legislature could provide for payment of retired teachers' pensions out of the general school funds. In 1938, the General Assembly enacted the Teachers' Retirement Act of 1938, which made provision for the continuance of pension payments to retired teachers on the retirement roll of the local system at the time of its discontinuance and merger into the state system. *Id.* at 339. The 1938 Act provided that the payment of benefits to members on the retired roll at the time of discontinuance would become the obligation of the local school district. *Id.* The 1938 Act also provided that the amount of refundable deposits due to each member would be paid to any member not on the retirement roll. If the remaining sum was less than the present value of liabilities, the 1938 Act required the local district to levy a

mandatory tax to discharge in full liabilities to the annuitants. In Louisville, after the payment of all "refundable deposits" in the local fund, only $5,800 remained with which to pay annuities to pensioners on the retirement roll. The Board of Aldermen refused to levy the tax, and the local Board of Education filed suit.

The Court first found unconstitutional that portion of the 1938 Act which required the imposition of a mandatory tax because the title of the legislation under consideration made no mention of a mandatory tax levy. *Id.* at 341. Kentucky's Constitution requires that the subject of a legislative act be expressed in its title.

The Board of Education also asked the Court to rule on whether it could pay its pension obligations out of its general funds. Reviewing the history of Louisville plan and its funding, the Court observed as follows:

> It appears that one-half of every dollar paid into the fund was ear-marked for each contributor individually, and that the other half for all of them collectively. Now that a final accounting must be had, it is found that the plan was *unsound actuarily* [sic] and the fund set apart for collective use for payment of vested annuities has been diminished to a negligible sum. The question is, What shall be done about it to protect the rights of the eighty-five retired teachers? [Emphasis added.]

Id. at 343. Thus, the concept of "actuarial soundness" entered Kentucky's jurisprudence. The Court went on to determine that the annuitants on the retirement roll had vested rights under a contract, stating as follows:

> They had a contract with an agency of the Commonwealth of Kentucky entitling them to the benefits for which they had paid. The strength of every contract lies in the right of the promise to rely upon the constitutional security against impairment of its obligations by legislation and in the right to resort to courts of public justice for the redress of its violation. [Emphasis added.]

Id. The Court noted that, when the 1938 Act was adopted, "the retired beneficiaries had acquired a vested right to the annuities which could not be impaired by legislative action." *Id.* at 344. The Court distinguished *Head* and *Rohe*, which had found the involved pensions to be gratuities, because the pension would be paid for by state taxation rather than by compulsory deductions. The Court found that the teachers' pensions were not impermissible private emoluments under the Kentucky Constitution. *Id.* at 345. Citing *Talbott*, the Court noted that the pensions were compensation, the payment of which was deferred. *Id.* The Court ultimately determined that it was competent for the General Assembly to provide for the payment of retired teachers' pensions out of general school funds. *Id.* at 346.

The City of Louisville then objected to paying the "refundable deposits" to current teachers, contending instead that these amounts only could be paid as the teachers retired. This position resulted in additional litigation. In *City of Louisville v. Board of Education of Louisville*,

163 S.W.2d 23 (Ky. 1942), the Court held that the teachers were entitled to the present distribution of the refundable deposits. The Court reasoned as follows:

> Under the 1912 act establishing the local teachers pension system, it was expressly provided that contributors should have the right to a refund of one-half the sums they had paid in if and when they ceased to teach before becoming entitled to an annuity. That was one of the conditions of the contract. We doubt if the legislature could have destroyed that right any more than it could have destroyed the vested rights of the pensioned teachers as declared in the first case involving this matter.

Id. at 25. Thus, the Court enforced the contractual rights, not only to vested pensioners on the current retirement rolls, but also those of actively employed teachers.

In *Arnold v. Browning*, 171 S.W.2d 239 (Ky. 1943), the Court further clarified when a pensioner or beneficiary has a vested right to a pension, holding that the law in existence at the time of the husband's death controlled the determination of his widow's pension rights. In 1903, Ethel Arnold married an employee of the Louisville Fire Department. In 1917, Mrs. Arnold divorced her husband. In 1925, Mr. Arnold retired from the Louisville Fire Department due to disability and begin receiving a pension benefit. In 1935, the Arnolds remarried and remained together until his death in 1941. *Id.* In 1938, the General Assembly enacted a change to firemen pension laws that provided that a beneficiary would be entitled to a survivor benefit only if the beneficiary was married to the pensioner at the time of retirement. *Id.* at 240. Mrs. Arnold attempted to argue that her rights to the survivor benefit vested upon their re-marriage under the terms of the 1912 law. Citing *Miller*, the Court emphasized, "It is only when by the terms of the act providing for the fund, the claimant is shown to become entitled to the benefits that the right thereto has vested." *Id.* Finding that Mrs. Arnold would not have been entitled to any payment of a survivor benefit until her husband's death, the Court determined that she had no vested right to the pension. Accordingly, the Court applied the 1938 Act and denied her claim. Mrs. Arnold also contended that members of the board had prevailed upon her to remarry Mr. Arnold, assuring her that, in the event of his death, she would receive the pension granted to him. She argued that representations to her by individual members of the board should be binding upon the board. *Id.* The Court found that she was not entitled to rely on such representations.

The City of Owensboro created, repealed, and then attempted to revive a pension fund for all of its departments, excepting its fire and police departments. The mayor filed an action for a declaration of rights. In *City of Owensboro v. Board of Trustees, City of Owensboro Employees Pension Fund*, 190 S.W.2d 1005 (Ky. 1945), the Court upheld the 1939 enactment of the pension plan. *Id.* at 1008. The Court similarly found its 1940 repeal to be valid - but not the attempted re-enactment in 1941. *Id.* With respect to the repeal, the Court stated, "It must be admitted, however, that the repeal of it, pursuant to KRS 446.110, did not and could not affect the vested rights and the inviolable contract of the employees who became such, and qualified under the Civil Service Ordinance within its operative life." *Id.* Thus, while recognizing the validity of the repeal, the Court upheld the vested rights under an "inviolable contract." The Court also rejected an argument of estoppel as against Owensboro because of its conduct toward the employees and its attitude toward, and recognition of, the force of the pension ordinance after its

repeal. The Court emphasized, "Our courts have held specifically that any statute or ordinance passed in contravention of the Constitution is without force or effect, and any action had or taken under such ordinance is a nullity, and that from a nullity no rights can arise and by it no rights are affected." *Id.* 1008-1009. Accordingly, the Court did not find that Owensboro was estopped from not offering pension coverage.

The cases from the 1940s added several principles to Kentucky's law governing public pensions. First, Kentucky started to recognize pensions as deferred compensation for services rendered to the Commonwealth - rather than as a gratuitous "bounty" to be given or taken away at the sovereign's will. Second, Kentucky recognized - at least with respect to vested rights - that pension rights were contractual in nature and should not be impaired by subsequent, retroactive legislation. Kentucky courts will look to the governing statutes to determine pension rights, not to the representations or conduct of the public employer. Finally, the concepts of "actuarial soundness" and "inviolable contract" entered Kentucky's pension jurisprudence. *City of Louisville I; City of Owensboro*.

3. "Inviolable Contract" - Impairment Clause Jurisprudence.

Almost 30 years would pass before Kentucky's Court of highest resort again would consider the nature of public employees' pension rights. *See* OAG 78-4, 1978 WL -5 26830, at *1. In the interim, two things happened that dramatically altered subsequent jurisprudence on public pension and retirement benefit rights in Kentucky. First, the General Assembly enacted various statutes providing that KERS, SPRS and CERS each constituted an "inviolable contract" of the Commonwealth. KRS 61.692; KRS 16.652; and KRS 78.852. These "inviolable contract" provisions changed the analysis that determined whether members of the retirement systems would have vested rights to retirement benefits.

In an important national constitutional development, the Supreme Court of the United States revitalized Contract Clause jurisprudence in *United States Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977) ("*U.S. Trust*"). The Court set forth principles to determine whether a legislative act was an unconstitutional impairment of a contract under the Contract Clause. Courts elsewhere in the United States have employed this analysis extensively in adjudicating claims that public pension rights had been impaired by subsequent legislation or budget decisions. (See Heading E.4, pp. 31-32, infra.)

In Kentucky, the *U.S. Trust* formula has only been used to test Contract Clause impairment complaints in opinions of the Kentucky Attorney General, testing proposed statutes' effect on Kentucky retirement laws, (see OAG 04-001 (2004) (proposed retrospective legislation to bar "double-dipping" by re-employment after retirement), and OAG 94-28 (1994) (retroactive forfeiture of pension after legislator's felony conviction).

The *Jones* opinion (p. 20, infra) distinguished *U.S. Trust* as a case from another jurisdiction and, having found no contract impairment, did not pursue the other analytic steps required by *U.S. Trust* – although it adverted to public need and budgetary necessity. 910 S.W.2d at 714.

One of the first modern cases involved the enforcement of a statute permitting the refund of contributions upon an employee's withdrawal from service. In *Policemen's and Firemen's Retirement Fund of the City of Newport v. Shields*, 521 S.W.2d 82 (Ky. 1975), the court held that an employee was entitled to a refund of his retirement plan contributions upon withdrawal of service, even though he was involuntarily separated from service, because KRS 95.877 gave him a vested right in his contribution and did not place any qualification on the extent of that right. The Court stated, "The rights of persons participating in a pension plan are governed entirely by the terms of the pension plan and the statutes under which it is operated." *Id.* at 83. The Court observed that the statute specifically provided for the refund of contributions, without interest, upon withdrawal from service. *Id.* Although the Court found no specific authority addressing whether "withdrawal from service" included termination for cause, the Court held that KRS 95.877 gave the member a vested right to their contributions. The Court concluded, "In view of the sacredness attached by the law to vested rights, and since KRS 95.877 does not place any qualification on the extent of the vested rights it gives, we think [withdrawal from service] cannot properly be construed as by implication divesting contribution rights in the case of an involuntary separation from service." *Id.* Thus, the Court upheld the member's right to the refund of his contributions.

On the other hand, in *Louisville Policemen's Retirement Fund v. Bryant*, 556 S.W.2d 6 (Ky. 1977), in which the involved statutes required five years of service in which to vest in a right to a contribution refund, the Court found that the member who had served for less than five years was not entitled to a refund of his retirement plan contributions. Neither of these cases specifically involved an "inviolable contract" provision, although both construed provisions regarding the vesting of refund rights.

The 1970s brought a series of opinions from the Office of the Attorney General addressing the effect of the "inviolable contract" provisions on KERS, SPRS, CERS, and, eventually KTRS. While these opinions are not mandatory authority for courts in Kentucky, "This Court may give 'great weight' to the reasoning and opinion expressed in Attorney General's opinions. York v. Commonwealth, Ky. App., 815 S.W.2d 415, 417 (1991)," cited in *Woodward, Hobson & Fulton, L.L.P. v. Revenue Cabinet*, 69 S.W.3d 476, 480 (Ky. App. 2002). These opinions do constitute persuasive authority because they consider the impact of the "inviolable contract" statutes.

In OAG 78-4, the Attorney General was asked to opine whether it would be lawful to limit the retirement benefits under KERS, SPRS and CERS such that the retirement benefits, plus Social Security benefits, would not exceed either 90% or 100% of a member's final annual salary. The Attorney General concluded that the enactment of the "inviolable contract" provisions constitutionally foreclosed the General Assembly from enacting legislation creating a limit on retirement pensions. The opinion observed, "With the exception of KTRS, all other public retirement systems in question have enacted statutes stating in effect that the respective retirement statutes of each system `shall constitute an inviolable contract of the Commonwealth' and the benefits provided by those statutes could not therefore be subject to reduction or impairment by alteration, amendment or repeal." *Id.* at *1. In light of this statutory authority, the Attorney General opined that the General Assembly could not limit retirement benefits to certain maximum percentages of final salaries because of the Commonwealth's creation of a contractual obligation with the members of the involved retirement systems. *Id.* at *2. The

Attorney General found that the imposition of such limitations, both with respect to retired and non-retired members, would violate both state and federal constitutional provisions. *Id.* The Attorney General noted that its opinion comported with current trends in public pension law, which are "predicated upon the theory that such pensions are actually a part of compensation (deferred in nature) to which the public employee is entitled for services rendered, and in which he has certain rights which cannot be abrogated at the will of the government." *Id.* Interestingly, even in the absence of the "inviolable contract" provision at the time, the Attorney General opined that the same concept would apply to pensions under KTRS. *Id.* at *3. The Attorney General concluded as follows:

> It is our opinion that the General Assembly may apply a percentage limitation on retirement benefits as you have suggested in your letter but that such a limitation may be applied on prospectively as to present non-retired members and, of course, all future members of the five public retirement systems in question in light of the contractual obligation of the Commonwealth. Such a limitation could not be applied retroactively to any member, retired or otherwise, but could only effect their retirement accounts and eligibility benefits insofar as such rights and benefits accrued after the date of enactment of such law.

Id. Thus, OAG 78-4 at least would permit the Legislature to limit the pension benefits of system members whose "rights and benefits" had not yet accrued.

Although involving a city policemen's and firemen's pension fund, OAG 81-318, 1981 WL 142127, also warrants mention. The Attorney General was asked to opine whether recipient widows already receiving a pension benefit under KRS 95.550 could have their pensions reduced by the local board of trustees for the pension fund, due to a shortage in the pension fund. It was also asked whether future pensions of widows could be reduced. The Attorney General first noted that vested contractual pension benefits could be modified prior to retirement to accommodate changing conditions, provided that the modifications were reasonable and that disadvantages to employees were accompanied by comparable new advantages. *Id.* The Attorney General cited *Miller* for the proposition that a member not placed on the retired list did not have vested rights even though the fund was partially comprised of an involuntary monthly assessment on salaries. *Id.* at *2. The Attorney General opined that once the person fulfilled the requirements for a pension and the pension became due, the recipient acquired vested rights in the pension which could not be altered or abolished (except pursuant to KRS 95.610(3), permitting a pro rata reduction in the event of insufficient funds). *Id.* at *3.

OAG 81-416, 1981 WL 142048, represented an important change in the Office of Attorney General's opinion regarding the rights under the "inviolable contract." By this time, an "inviolable contract" provision had been added to KTRS. KRS 161.714. The Attorney General was asked to opine whether certain restrictions, such as setting a maximum salary limit for which retirement credit would be allowed, could be mandated for current or future members of KTRS. The Attorney General began by noting that "the trend in public retirement system law is that, with or without specific statutory language, the courts have often found a contractual relationship between the member and the state or local government with which he is employed." *Id.* at *1.

Construing the "inviolable contract" provision, the Attorney General stated, "In other words, the General Assembly may not enact any law which would impair or reduce the expected retirement of any present or new teacher or those received by retired members." *Id.* at *2. The Attorney General concluded that "[t]he retirement system statutes may of course be amended to affect those individuals who will become members of the system on a future date." *Id.* Unlike OAG 78-4, OAG 81-416 appears to opine that the retirement system statutes may not be modified with respect to any current non-retired members - even with respect to benefits not already accrued. The opinion concluded, "To the extent that this opinion differs from OAG 78-4, that opinion is hereby modified."

In OAG 84-1, 1984 WL 185559, the Attorney General opined, in the absence of contrary authority, that a police officer participating in a local pension fund could not forfeit his pension benefits due to misconduct. Citing OAG 81.318, the Attorney General stated, "[o]nce a person has fulfilled the requirements for a pension and a pension has been granted, the recipient acquires vested rights in the pension fund and those rights and benefits can only be altered or abolished" under certain specific statutory circumstances. *Id.* at *1. The Attorney General then cited *City of Louisville II*, stating, "a person has no vested right in a pension system until he becomes an actual beneficiary." *Id.* Citing *Arnold*, the Attorney General noted, "it is only when by terms of the act providing for the pension fund, the claimant is shown to have come entitled to the benefits that the right to such benefits becomes a vested right." *Id.* Determining that whether misconduct can affect rights to a public pension depends in large part upon the terms of the enabling statute or ordinance and finding the relevant statutes to be silent, the Attorney General opined that the police officer could not be disqualified from his pension due to misconduct. *Id.* at *2.

In a similar vein, OAG 94-28, 1994 WL 171572, set forth the opinion of the Attorney General that, given the "inviolable contract" of the Legislative Retirement Plan, KRS 6.696 (enacted in 1993 and providing for the forfeiture of pension benefits of current and former legislators upon conviction of a felony related to his or her legislative duties) could not be given retroactive effect. KRS 6.525 expressly adopts an "inviolable contract" provision into the Legislative Retirement Plan. *Id.* at *2. The Attorney General rejected the argument that each legislative term could constitute a new contractual period. *Id.* at *3. The Attorney General cited *United States Trust* for the proposition that states retained some authority to modify contracts. The Attorney General concluded, "In our view, in order not to be violative of Section 19 of the Constitution of Kentucky and Article I, Section 10 of the Constitution of the United States, KRS 6.696 must be applied only as against one who became a member of the Legislators Retirement Plan on or after the effective date of such enactment, so that the provision would be considered a part of the retirement plan contract of a legislator in keeping with [the "inviolable contract" provision] as adopted by KRS 6.525." *Id.* With respect to the forfeiture of benefits, the Attorney General did not distinguish between benefits accrued before and after the enactment of KRS 6.696. The Attorney General did opine that it would be possible to attempt to recover benefits previously paid to a former member of the Legislative Retirement Plan following a pertinent felony conviction if such action were pursued with respect to benefits earned after the enactment of KRS 6.696 by a former member who became a member on or after the enactment date. *Id.* at *4.

4. "Inviolable Contract" - Funding the Kentucky Retirement Systems.

During times of budgetary difficulty, the General Assembly has occasionally considered utilizing extra funds from KERS, SPRS or CERS or reducing funding for the retirement systems.

In *Commonwealth v. Collins*, 709 S.W.2d 437 (Ky. 1986), the Court held that an appropriations bill that called for the transfer of money from agencies in which public funds and private employee contributions were commingled was unconstitutional. The Court noted that when any affected agency, board, commission, or other entity of state government receives fees, rental, sales, bond proceeds, gifts, or other income, those moneys are specifically appropriated by the General Assembly to those units. *Id.* at 446. In the 1984 biennial budget bill, the General Assembly provided for the "suspension" of certain statutes to provide for the transfer of certain agency and special funds to the general fund. *Id.* The Court observed, "We repeat ourselves when we say that the General Assembly has, constitutionally speaking, the power in a budget bill to repeal or amend the manner in which public funds are used." *Id.* That said, the Court went on to say, "However, the transfers of funds which relate to appropriations of private contributions cannot be termed suspensions or modifications of the operation of the statutes." *Id.* Accordingly, the Court found unconstitutional the transfer of money from agencies in which public funds and private employee contributions are commingled. *Id.* The Court stated, "Diversion from the Kentucky Employees Retirement System, County Employees Retirement System, State Police Retirement System, and Teachers' Retirement System fall within this category...." *Id.* 446-447.

In 1988, the General Assembly again directed in a budget bill that funds be directed from the Kentucky Retirement Systems into the general fund. The appropriation, however, specified that it was to be made only from the employer's share of contributions. In OAG 90-6, the Attorney General opined that, despite the different accounting "maneuver," the transfer was unconstitutional under *Collins*. In addition, the Attorney General opined that the transfers would violate the Kentucky and United States Constitutions because they violate KRS 61.692, which provides for the "inviolable contract" of the Commonwealth. *Id.* The Attorney General stated, "In addition to this expectation of future benefits, the state public retirement statutes provide that the pension fund be administered on an actuarially sound basis and requires that the board of trustees of the retirement system determine the employer's normal contribution rate and past service contribution rates on an annual actuarial basis." *Id.* The Attorney General continued, "In other words, the employee has a contractual interest not only in future benefits but in the security and integrity of the source of funds available to pay future benefits on a long term basis." (Emphasis original.) *Id.* The Attorney General found that there was no evidence that the fund transfer from the Kentucky Retirement Systems was either necessary or appropriate under the circumstances. *Id.* The Attorney General also noted that there was no provision in the budget bill for the replacement of transferred funds in the future - contributions transferred appears to be irretrievably lost. *Id.* Accordingly, the Attorney General opined that the transfers contemplated by the budget bill constituted an unconstitutional impairment of the "inviolable contract" provisions of the Kentucky Retirement Systems.

The extent to which the General Assembly should defer to the Board in determining actuarial assumptions to set employer contribution rates under KRS 61.565 was considered in *Jones v. Board of Trustees of Kentucky Retirement Systems,* 910 S.W.2d 710 (Ky. 1995). In

September 1991, the Board's actuary determined that state contributions to the retirement fund should be increased because of losses in investment return, salary increases, and expected increased in medical premium rates. *Jones*, 910 S.W.2d at 712. The Board adopted the actuary's proposed increases and included them in its budget request. *Id.*

Governor Jones, however, rejected the Board's recommendations. *Id.* He submitted a state rate of contribution, beginning July 1, 1992, which was the same as the rate for the prior plan year. *Id.* Although the Governor did not employ actuarial assistance, the Governor stated that it would be more reasonable to value retirement fund assets using market value, rather than book value, which was used by the Board. *Id.* The General Assembly adopted the rates for the prior year proposed by the Governor in the 1992 Budget Bill. *Id.* The Board eventually adopted the market rate approach, although the Board continued its request for the higher levels of employer contributions due to the expected increase in retiree medical obligations. *Id.*

The Board filed a Petition for Declaration of Rights, asserting the following claims:

- The 1992 Budget Bill usurped the authority of the Board independently to set actuarially sound employer contribution rates;

- The failure to meet the Board's contribution rates impaired KERS members' contract rights under KRS 61.692;

- The alleged failure constituted a violation of Section 19 of the Kentucky Constitution (which prohibits the enactment of ex post facto laws or laws impairing the obligation of contracts); and

- The alleged failure violated Article I, Section 10 (*i.e.*, the "Contract Clause") of the United States Constitution.[*] *Id.*

The Franklin Circuit Court granted summary judgment in favor of the Board, finding that the Budget Bill was void as an unlawful impairment of the KERS members' inviolable contract rights. *Id.*

In *Jones*, the Court reversed the Circuit Court, holding, "We conclude that since there was no showing that any benefit commitment made to KERS members was infringed, or threatened, the Board had no power to mandate rates of contribution and require their adoption." *Id.* at 713. The Court opened its analysis by stating, "The crucial issue before us is whether the General Assembly must blindly defer to the Board in matters of state retirement funding." *Id.* The Court reasoned:

> We have acknowledged that KERS members have a contractual right to the benefits they were promised upon retirement. Any reduction ***or demonstrable threat*** to those promised benefits might well run afoul of Section 19 of the Kentucky Constitution, but ***we***

[*] The claim also asserted violations of the Fifth and Fourteenth Amendments of the United States Constitution.

> ***can leave that issue for another day***. In the present case there has been only a refusal by the executive and legislative branches of government to adhere to the Board's suggested funding rates. There has been no showing that the retirement benefits promised to KERS members ***have been or will be infringed*** by the failure to adopt the Board's recommendations.

Id. (Emphases added.) In the absence of a finding that promised retirement benefits might be infringed or demonstrably threatened, the Court held there was no violation of Section 19 of the Kentucky Constitution.

While acknowledging the Board's function in managing KERS and in suggesting employer contribution rates determined upon actuarial bases (see KRS 61.565), the Court held that there could not be an unrestricted right to demand funding from the General Assembly. Explaining the temporary suspension of KRS 61.565, the Court stated as follows:

> While appellees assert that the suspension of the statute was a constitutional violation in that the statute suspended is a contractual right, such is without merit. The contract between the Commonwealth and its employees is for retirement funding. It is not a contract which denies the General Assembly the ability to fashion its ways or means in providing the pension funds.

Id., 713-714. The Court then noted the current budget shortfall and the need for the General Assembly to take steps to ensure the continued operation of the government.

The Court also considered the actuarial assumptions used by the Board to value retirement fund assets and to set the employer contribution rates. The Court observed that using market value rather than book value increased the value of retirement fund assets by $322 million. The Court calculated that using market value to value retirement fund assets would have resulted in employer contribution rates substantially the same as, or even lower than, the rates set by the General Assembly. The Court also noted that Kentucky was one of very few states to attempt to pre-fund retiree medical coverage - most states employing a pay as you go method. *Id.* at 715.

In *Valdes v. Cory*, 139 Cal. App. 3d 773 (1983), the California Court of Appeals held that the action of the legislature suspending all contributions to the public employees' pension plan for three months impaired California's contractual obligations to its workers. The court held that the action infringed on the employees' interests "in the security and integrity of the funds available to pay future benefits." *Id.* at 222. In *Valdes*, the legislature had ordered that the amount of the shortfall be covered by taking money from the reserve against the deficiencies portion of the retirement fund. The Kentucky Supreme Court distinguished *Valdes* by noting that in California a complete suspension of employer contributions had occurred and that there had been a raid on the pension plan's reserve fund. *Jones*, at 715. The Kentucky General Assembly in 1992 only had determined that the Board had used inappropriately high actuarial assumptions to set the employer contribution rate. The Court also distinguished *Dadisman v. Moore*, 384 S.E.2d 816 (W.Va. 1988), in which the West Virginia Supreme Court had held that

the legislature's four-year suspension of contributions to the state pension fund violated statutory requirements and substantially impaired the contractual rights of all state employees. The Court noted that there was no impairment of pension rights nor any violation of Kentucky statute. *Jones*, at 716. The Court concluded by stating, "As appellees have shown no substantial impairment in their contractual rights by the actions of the General Assembly, we need not decide under what circumstances the state's contract with its workers could be lawfully impaired." *Id.*[†]

In *Jones*, the Court was able to "leave that issue for another day" the issue of whether a "demonstrable threat" to promised retirement benefits would run afoul of Section 19 of the Kentucky Constitution and the Contract Clause of the United States Constitution. *Id.*, at 713. On the one hand, *Jones* is very clear that the inviolable contract not to be impaired is a contract "for retirement funding." *Id.*, at 713-714. On the other, *Jones* insists that KRS 61.565 does not delegate to the Board the right unilaterally to impose employer contribution rates on the Commonwealth and that it is the prerogative of the General Assembly to balance the budget. *Id.* at 714. With respect to its finding of non-impairment, the Court seemed to draw comfort from the facts that (i) the Board's actuary ultimately adopted the market value assumptions suggested by the Governor, (ii) the use of these different actuarial assumptions for the involved year would have kept the employer contributions more or less constant from the prior year, and (iii) Kentucky was one of very few states to attempt to pre-fund retiree medical benefits to public employees. *Id.* These factors combined to suggest that the rates set by the General Assembly were not without reasonable actuarial bases. *Jones* indicates that the Court might take a much harder look at employer contribution rates that bear no rational relationship to generally accepted actuarial bases. Furthermore, in *Jones*, there was no showing that maintaining the same employer contribution rate would impair the promised benefits. As the gap between the amount requested by the Board and the amount approved by the General Assembly increases, and as the amount of unfunded vested accrued benefits under Kentucky's public employees retirement systems increases, the possibility of impermissible impairment of promised benefits grows. *Jones* gives very little guidance about what constitutes a "demonstrable threat" to promised benefits. While *Jones* defers greatly to the General Assembly's budget-making authority, it is clear that the General Assembly's authority might be subject to judicial review to the extent that promised benefits might be demonstrably threatened by the level of funding. *Id.*

Although the Kentucky Supreme Court in *Jones* "left for another day" the question whether a "demonstrable threat" to the retirement benefits that KERS members were promised would violate the Kentucky constitution, authorities from other states indicate that courts will find that the contractual and constitutional rights of public employees and retirees have been unlawfully infringed only where the enforcers of contractual rights have shown that legislation

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[†] The Kentucky Supreme Court also cited, as cases from "other jurisdictions" and factually distinguishable, *U. S. Trust* and *Indiana ex re. Anderson v. Brand*, 303 U.S. 95 (1938), two United States Supreme Court cases involving the Contracts Clause of the United States Constitution. Although the court in *Valdes* relied on these cases in finding an unconstitutional impairment of contractual rights, neither case specifically involved the funding of public retirement plans. Finding that no benefit rights had been impaired, the Kentucky Supreme Court did not directly analyze either of these cases.

that changes funding methods, payment timing, contribution rates or other actions will render the retirement fund "actuarially unsound." Following *Valdes*, courts have held that public employees have not only a contractual right to payment of promised retirement benefits, but also a protected interest "in the security and integrity of the funds available to pay future benefits." *Valdes*, 139 Cal.App.3d at 785; *Dadisman I*, 181 W.Va. at 790-791. A pension fund that is "actuarially unsound" infringes on those rights, regardless of whether any retiree has actually suffered an out-of-pocket loss by not receiving all of the retirement benefits promised to him. *Valdes*, 139 Cal.App.3d at 785. As the court explained in *Dombrowski*, a public employee will be deemed to have suffered "a present impairment of his contractual rights and thus an immediate injury" if it is shown that the retirement system is "actuarially unsound." *Dombrowski*, 431 Pa. at 214-215. Thus, an unlawful impairment of the inviolable contract due to a "demonstrable threat" to promised retirement benefits may be found if a court were to determine in a future case that the one or more of the Kentucky retirement systems was "actuarially unsound," as the court in *Dombrowski* found with respect to its retirement system, after receiving actuarial evidence.

Courts outside Kentucky also appear to place greater weight on the findings of the retirement board's actuary than did the Kentucky Supreme Court in *Jones*. *Valdes*, for example, emphasized that the level of employer contributions to the retirement fund could not be reduced "unless and until such time as the board *or* the Legislature, after due consideration of the actuarial recommendations by the board, deems such contributions inappropriate." *Valdes*, 139 Cal.App.3d at 787. In holding that a three-month suspension of employer contributions was unlawful, the *Valdes* Court noted that "no evidence was presented that the Legislature had received guidance from the PERS Board's actuary on the consequences of the legislation calling for this suspension," (*id*.), whereas the *Jones* court had before it competing evidence gathered by other actuaries supporting the position that no damage had been done to the benefits. Similarly, in *McDermott*, the New York court held that a law requiring the retirement system trustee to use a different actuarial method than the one the trustee had been using to determine annual employer contributions violated the employees' contractual rights "providing that their pensions would be funded and secure." *McDermott*, 587 N.Y.S. 2d at 141. The court found that the employees had a contractual "right to an independent trustee imbued with discretion to protect their investment funds." *Id*. at 142.

By contrast, the *Jones* Court upheld the Governor's decision not to follow the recommendation of the Board's actuary to increase the state's rate of contribution to the retirement system. The Court concluded that "since there was no showing that any benefit commitment made to the KERS members was infringed, or threatened, the Board has no power to mandate rates of contribution and require their adoption." *Jones*, 910 S.W.2d at 713. As discussed above, the outcome of that case – and of future cases – may be different if sufficient evidence were presented to show that level of funding recommended by the Board's actuary was necessary to prevent actuarial unsoundness of the system.

What is clear from all the cases, however, is that even a trustee to whom the task of obtaining actuarial information is entrusted must be prepared to demonstrate that any proposed change to which that trustee objects must be supported by demonstration that it is actuarially unsound.

5. Open Questions Under Jones

Remaining open since the *Jones* opinion are questions like the following:

1. What degree of "reduction or demonstrable threats" to benefits would violate the Kentucky Constitution, § 19, and what factually would rise to those levels;

2. Whether the inviolable contract could be "lawfully impaired" as suggested at the end of the *Jones* Opinion – dictum, since there was in fact no proof of impairment before that court. Since *Jones*, there have been few Kentucky pronouncements measuring the provisions of the inviolable contract referred to in the statutes. We summarize them below.

As discussed above, the Kentucky Supreme Court in *Jones* held that the Governor's decision to use the same rate of contribution to the retirement system that had been used in the previous year, rather than adopt the recommendation of the Board and its actuary to increase the state's contribution, was not an unlawful impairment of the public employees' "inviolable contract" rights because "there was no showing that any benefit commitment made to KERS members was infringed, or threatened." *Jones*, 910 S.W.2d at 713.

The *Jones* Court left open the question whether a "reduction or demonstrable threat" to the retirement benefits KERS members were promised "might well run afoul of Section 19 of the Kentucky Constitution." *Jones*, 910 S.W.2d at 713. With respect to an actual reduction in the benefits, the *Jones* opinion indicates that such an event would infringe the "inviolable contract" and run afoul of the constitution. The Court stated, "we recognize that the retirement savings system has created an inviolable contract between KERS members and the Commonwealth, and acknowledge that the General Assembly can take no action to reduce the benefits promised to participants." 910 S.W.2d at 713. The Court, however, did not give clear guidance on whether or to what extent a "demonstrable threat" to those benefits would constitute an infringement of the inviolable contract.

The Court distinguished cases from other states that involved "cuts in pension funding which resulted in endangerment of current and future pension benefits, thus resulting in a substantial impairment of the contractual pension rights of employees." *Jones*, 910 S.W.2d at 715. The Court found that the plaintiffs in *Jones* had "failed to show any infringement on those rights." *Id.*

One of the cases *Jones* distinguished on that account was *Valdes v. Cory*, 139 Cal.App.3d 773 (1983). In *Valdes*, the California Court of Appeal held that legislation requiring a three-month suspension of employer contributions to the Public Employees' Retirement System (PERS) was an unlawful impairment of the public employees' contract rights and a violation of the state and federal constitutions. The Court recited the following rules for determining if a change to an employee's pension rights is permissible:

> An employee's vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such

> modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, *and changes in a pension plan which result in disadvantages to employees should be accompanied by comparable new advantages*.

Valdes, 139 Cal.App.3d at 784.

The *Valdes* court acknowledged that the three-month suspension of employer contributions resulted in no out-of-pocket losses to employees, but stated, "the interest of the employees at issue here is in the security and integrity of the funds available to pay future benefits." *Valdes*, 139 Cal.App.3d at 785. The court held that the state was contractually required to pay the withheld appropriations to the PERS fund because the state was bound by its obligation "to make the statutorily set payment of monthly contributions to PERS unless and until such time as the board or the Legislature, after due consideration of the actuarial recommendations by the board, deems such contributions inappropriate." *Id*. at 787. The Court noted that no evidence was presented that the Legislature had received guidance from the PERS Board's actuary on the consequences of the legislation calling for the three-month suspension of employer contributions. *Id*.

The *Jones* Court distinguished *Valdes* on the grounds that, in *Valdes*, "a complete suspension of employer contributions occurred, and there was a raid on the reserve account to pay for the state's contribution;" whereas in *Jones* "the 1992 Budget Bill merely maintained the rate of contribution as that of the previous year." *Jones*, 910 S.W.2d at 715. The *Jones* Court therefore concluded, "[t]he 1992 Budget Bill did not impair the contractual rights of KERS members." *Id*.

6. Recent Developments.

In OAG 04-001, the Attorney General was asked to opine whether the General Assembly retroactively could amend KRS 61.637(7)(a) to prevent a practice known as "double dipping." In 1998, the General Assembly amended KRS 61.637 to allow retired members to be reemployed by a participating agency without the suspension of their retirement benefits. In addition, those members were allowed to begin a second retirement account to which they were permitted to make contributions. *Id.* at *3. The Attorney General first stated that KRS 61.637, in conjunction with KRS 61.692, gave retired members of the Kentucky Retirement Systems a contractual right to be reemployed in a position covered by the same retirement system without forfeiting their monthly retirement payments. *Id.* at *4. The Attorney General cited *Jones* as upholding the "inviolability" of the contract. The Attorney General explained, "[L]egislation retroactively prohibiting the practice of `double dipping' would, by design, infringe upon the retirement benefits promised to current members, so the question necessarily becomes whether such infringement constitutes a violation of the Contract Clause and Section 19." The opinion extensively discussed and relied upon the Contract Clause principles set forth in the *U.S. Trust* case, page 16, *supra*. *Id.* at *5. Finding that such an amendment would constitute an impairment of the inviolable contract, the Attorney General stated as follows:

> By definition, neither a retroactive amendment nor a repeal, if applied to current members of Kentucky Retirement Systems, could properly be characterized as the least drastic alternative available nor could the resulting impairment accurately be described as "minimal." Accordingly, it is our opinion that the ends would probably not justify the means in this context as the presumably fiscal motivation for the proposed legislation does not satisfy this intentionally high standard.

Id. at 14. The Attorney General noted that it is an "established principle" that the desire to reduce costs or limit public spending does not justify the abrogation or impairment of a public entity's contractual obligations. *Id.* Accordingly, the Attorney General concluded that "double dipping" could be prohibited only on a prospective basis.

In *Kurtsinger v. Board of Trustees of Kentucky Retirement Systems*, 2004 Ky. App. LEXIS 261, 2004 WL 912670 (Ky.App. 2004)[*], the Court held that the appellants, individually and as class representatives of active and retired Louisville professional firefighters, were persons who would receive or were receiving health care benefits under CERS (see Heading B.3.b, page 6, *supra*) pursuant to KRS 61.701(1)(a), had standing to sue the Board of Trustees of the Kentucky Retirement Systems to assert claims that they were not receiving the health benefits to which they were entitled by statute.

In describing their status as "persons who will receive or are receiving health care benefits by virtue of the County Employees Retirement System inclusion in KRS 61.702(1)(a)," the Court stated:

> The Board has arranged to provide for group hospital and medical insurance for the appellants through the insurance that is available to state employees. The guidelines for that insurance is established through KRS 18A.225. KRS 18A.225(2)(a) directs 'secretary of the Finance and Administration Cabinet, upon the recommendation of the secretary of the Personnel Cabinet, [to procure], . . . a policy or policies of group health care coverage. . . ." Health care insurance provided to state employees is required to contain, at a minimum, the same benefits as those provided under the Kentucky Kare Standard Plan effective January 1, 1994 (the 1994 Plan). KRS 18A.225(2)(a).
>
> 'Employee,' as relevant in this case, is defined as follows:
>
> 3. Any person who is a present or future recipient of a retirement allowance from the Kentucky Retirement Systems. . . .

[*] Unreported, not final and not citable as authority, on remand from the Supreme Court of Kentucky, 90 S.W.3d 454 (2002).

> KRS 18A. 225(1)(b)3. Appellants are all present or future recipients of a retirement allowance from the Kentucky Retirement Systems.

Based on this statute, the Court held that the appellants had a "real stake" in the controversy over whether they were receiving the health benefits to which they were entitled. *Id.* at *1. The Court also reversed the trial court for granting summary judgment to the Board of Trustees on the merits of the claim. The Court stated as follows:

> It appears that genuine issues of material fact exist with respect to whether the benefits provided for the time period covered by the complaint have comported with the requirement that they meet the 1994 Plan minimum. For instance, under the 1994 Plan an emergency room visit cost $25.00 while under the 1998 and 1999 Plans that were offered to the appellants the payment was more. Similar comparisons are found for immunizations, inpatient admission, and prescriptions, as well as other health care services.

Directly paraphrasing (and citing) *Jones*, the Court said that the appellants "have the right to the [health insurance] benefits they were promised as a result of their employment, at the level promised by the Commonwealth."

Limited authority though it is, the opinion suggests a linkage between KRS 18A.225 and for the retirement systems. What is unclear is whether the provisions of KRS 18A.225 are part of the inviolable contract applicable to those systems.

E. FEDERAL AND STATE LAW REGARDING THE OBLIGATIONS OF EMPLOYERS AND RIGHTS OF EMPLOYEES UNDER PUBLIC PENSIONS

This section describes the evolution of public pension law in the federal and other state courts and their treatment of medical and funding issues.

1. Evolution From Gratuity to Contractual Right

In the late nineteenth century "the unquestioned rule [was] is that a pension granted by the public authorities [was] is not a contractual obligation, but a gratuitous allowance, in the continuance of which the pensioner has no vested right." Annotation, Vested Right of Pensioner to Pension, 54 A.L.R. 943, 943 (1928). Furthermore, "the notion that public employees had enforceable pension claims arising out of their employment would have grated harshly on the minds and ears of a nation decades removed from current and acceptable philosophies of governmental labor relations." Rubin G. Cohn, Public Employee Retirement Plans – the Nature of the Employees' Rights, 1968 U. Ill. L.F. 32, 35-36. This view is exemplified in *Pennie v. Reis*, 132 U.S. 464, 469-72, 33 L. Ed. 426, 10 S. Ct. 149 (1889). That case held that a San Francisco police officer's compulsory contributions (of $264) to a "life and health insurance fund" did not entitle his estate on his death to the promised payment of $1,000 when the statute creating the fund had meanwhile been repealed. Despite being "called part of the officer's compensation," since he never received it or controlled it before the fund into which he made contributions from his salary was merged into another fund making new and different provisions

for distribution, the Court found that there was "no contract … no vested right … a mere expectancy … liable to be revoked or destroyed [and] "no right of property in him of which he or his representative has been deprived"" by the legislature (132 U.S. at 470-471). The case is considered to have adopted what has been called the "gratuity" approach, although in fact what it held was that the officer, by having been required to make his contribution and never having controlled the money, therefore had no "property right" in the money he had contributed.

The test frequently used to determine "the legal nature of the employees' interest" was whether the plan featured mandatory or voluntary participation; voluntary participation created contractual rights, mandatory participation only a gratuity. See *Pennie*, *supra*, 132 U.S. at 471 ("[i]f … he had been induced to contribute" [salary] "subject to his absolute control").

The earlier test – whether a plan exerts mandatory or only voluntary participation (voluntary participation creating contractual rights, mandatory participation a gratuity), could create inequity wherever employees who initially elected to participate in a voluntary pension plan would have contractual rights, while employees hired after the changeover to mandatory participation provisions would have only "an expectancy." *See, e.g., State ex rel. Public Employees Retirement Bd. v. Mechem*, 58 N.M. 495, 503, 273 P.2d 361, 365 (1954), where the statutes would let an educational employee voluntarily belong to the Public Employees Retirement Association (PERA) in addition to the mandatory Teachers Retirement Association (TRA), the predecessor of PERA. Using the voluntary/mandatory test, the employee voluntarily joining PERA would have a contractual right to PERA benefits but only an expectancy in the TRA benefits. In addition, because PERA membership was optional for current employees and mandatory for all new state employees when enacted in 1947, existing employees would have a contractual right to benefits whereas new employees would only have an expectancy. Thus, under the voluntary/mandatory test, similarly situated employees under PERA would have had significantly different rights. The self-evident absurdity of the voluntary/mandatory test led the New Mexico court to reject it, and the modern trend generally agrees that the voluntary/mandatory test became archaic and inappropriate, see *Pineman v. Oechslin*, 195 Conn. 405, 488 A.2d 803, 808 (Conn. 1985) , especially because most state pension programs are contributory. *See Annotation, Vested Right of Pensioner to Pension*, 52 A.L.R. 2d 437, 442 (1957).

The "gratuity" concept, though largely rejected, has not disappeared. *See Board of Education v. Louisville*, 288 Ky. 656, 671, 157 S.W.2d 337, 345 (1941), dealing with a city's attempt to levy a special tax to pick up an apparent gap in payments when its local retirement system was merged with a state-wide system:

> The granting of a pension under such circumstances does not stand on the plane of a contract and does not vest any right in the pensioner. It is a periodical allowance as a reward for continuous faithfulness in the discharge of a public duty, or a gratuity bestowed in recognition of public service of some class or group.

Among the states, only Texas and Indiana currently adhere to what is characterized as the gratuity or bounty approach. *Ballard v. Board of Trustees of Police Pension Fund*, 263 Ind. 79, 82, 324 N.E.2d 813 (1975), *cert. denied*, 423 U.S. 806:

> … in Indiana pensions under a state compulsory contribution plan like the Police Pension Fund have traditionally been considered gratuities from the sovereign …

Cook v. Employees Retirement System, 514 S.W.2d 329 (Tex. App. 1974), citing and relying on *Dallas v. Trammell*, 129 Tex. 150, 157-158, 101 S.W.2d 1009, 112 A.L.R. 997 (1939) ("[p]ensions are in the nature of bounties of the government, which it has the right to give, withhold, distribution or recall at its discretion"). (*Cook* is not so much a gratuity case as a case justifying the right of the government to reduce or revoke a pension at any time prior to the time the employee actually is entitled to receive payment of the pension. In this connection, it differentiates between a plan that is voluntary, which it characterizes as an annuity, and a compulsory plan.) Some courts though avoiding the language of gratuity, cling to the notion that a state-sponsored retirement plan for public employees creates no enforceable contractual rights. *See, e.g., Pineman v. Oechslin*, 195 Conn. 405, 488 A.2d 803, 809-10 (Conn. 1985) (a right entitled only to due process); *Spiller v. State*, 627 A.2d 513, 516 (Me. 1993) (following *Pineman*).

2. Federal Cases

The United States Supreme Court has offered minimal authority recognizing any rights public employees have in their pensions. See *Pennie v. Reis*, 80 Cal. 266, 22 Pac.176, *aff'd* 132 U.S. 464 (1889). Despite criticisms that label *Pennie* outdated, harsh and unjust, the lower federal courts still support its holding, albeit grudgingly. *See, e.g., Zucker v. United States*, 578 F.Supp. 1239, 1243 (S.D.N.Y 1984) (Federal civil service retirees' claim to a constitutionally protected property interest rejected, based on "85 years of unbroken Constitutional law at the Federal level," based on *Pennie*, which the court was "constrained" to follow), *aff'd*, 758 F.2d 637 (Fed. Cir. 1985), *cert. denied*, 474 U.S. 842 (1985); *Muzquiz v. City of San Antonio*, 378 F.Supp. 949, 955-960 (W.D. Tex. 1974) (rejecting Due Process and Equal Protection claims of unconstitutionally of statute barring refunds of pension contributions to departing employees, and describing *Pennie* as "leading case and "harsh" (id. at 958)), *aff'd*, 520 F.2d 993, 1001-1002 (5th Cir. 1975) (no "talking"); *Transport Workers Union [etc.] v. SEPTA*, 145 F.3d 619, 623 (3d Cir. 1998), holding that a Pennsylvania public plan did not violate either state or federal constitutional contract clauses where the public plan expressly reserved a right of modification; commenting that "while *Pennie* has never been expressly overruled, most state supreme courts have subsequently rejected the "gratuity" approach in favor of an approach that viewed such programs as creating implied-in-fact unilateral contracts. *See also Parker v. Wakelin*, 123 F.3d 1, 6 (1st Cir. 1997) ("*Pennie* . . . ignored as a precedent," but no unamendable contract created by Maine statute). More recently, the United States Supreme Court in *United States R.R. Retirement Bd. v. Fritz*, 449 U.S. 166, 175-179 (1980), while stating that "railroad [retirement] benefits, like social security benefits, are not contractual and may be altered or even eliminated at any time," based the holding on the statute, not the *Pennie* case, which was not mentioned in upholding an "unartfully drawn" attempt to cure "windfall" benefits against Fifth Amendment (due process) attack.

Although the usual litigation over public pension matters involves citizens of the same state and therefore precludes diversity jurisdiction, the argument over federal constitutional issues, especially the federal Contracts Clause (Article 1, Section 10), can result in federal

consideration of these issues, including litigation over the critical times or events at which public pension rights become protected from change where no express right to modify is reserved by the public employer. See *Transport Workers Union [etc.] v. SEPTA*, 145 F.3d 619, 622-624, (3d Cir. 1998), holding that a Pennsylvania transportation authority's modification of a retirement plan to require contribution from employee earnings did not violate the Contracts Clause of the federal and state constitutions when there was an express provision reserving the right to "discontinue, suspend or reduce [SEPTA's] contributions" to the plan or the terminated.

Parker v. Wakelin, 123 F.3d 1 (1stCir. 1997), itself deciding that there was no clear intent in Maine's statute to create the contractual right claimed, summarized two other circuits' decisions on state retirement constitutional controversies:

The Ninth Circuit in *Nevada Employees Assoc., Inc. v. Keating*, 903 F.2d 1223 (9th Cir. 1990), agreed with the Nevada Supreme Court that the "'better reasoned view' recognizes that non-vested employees have contractual rights in pension plans 'subject to reasonable modification in order to keep the system flexible to meet changing conditions, and to maintain the actuarial soundness of the system.'" 903 F.2d at 1227 (quoting *Public Employees' Retirement Board v. Washoe*, 96 Nev. 718, 615 P.2d 972 (1980)).

Thus the Ninth Circuit in *Keating* concluded that a Nevada law penalizing the withdrawal of pension contributions and thereby altering the previous law that contained no such penalty, violated the Contract Clause because it did not represent a reasonable modification of the pension plan. The court in *Keating* noted, however, that the state did not dispute that Nevada's statutes providing pensions for public employees created contractual obligations. See *Keating*, 903 F.2d at 1225-26.

The Fourth Circuit also ignored the gratuity approach in the course of holding that legislative amendments to a North Carolina public employee disability benefit plan did not violate the Contracts Clause because, under relevant state law interpretations of the statute, rights to benefits under the plan did not vest until retirement. *See Kestler v. Board of Trustees of North Carolina Local Governmental Employees' Retirement Sys.*, 48 F.3d 800, 804 (4th Cir. 1995) (no Contract Clause violation where plaintiff was not vested at the time of the effective date of the amendment).

3. The Federal Test for a Contract

Although, as noted in the previously quoted opinion, the classification of state and local pension rights generally is a matter of state law, yet, in determining whether a contract was in fact established for federal constitutional purposes, the matter of federal constitutional rights is decided by federal law. Cf. *General Motors Corp. v. Romein*, 503 U.S. 181, 187 (1992), affirming the Michigan Supreme Court's decision that no contract was impaired by a state statute requiring refunds of withheld benefits. Federal courts "accord respectful consideration and great weight to the views of the State's highest court, though ultimately [federal courts] are bound to decide for ourselves whether a contract was made. *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938) [reversing state court's decision of "no contractual right"]. The question whether a contract was made is a federal question for purposes of Contract Clause analysis, see *Irving Trust Co. v. Day*, 314 U.S. 556, 561 (1942), and "whether it turns on issues of general or purely

local law, we can not surrender the duty to exercise our own judgment. *Appleby v. City of New York*, 271 U.S. 364, 380 (1926)." Thereupon, the Supreme Court, exercising its independent judgment, agreed with the Michigan Supreme Court.

Accord, *Koster v. City of Davenport et al.*, 183 F.3d 762, 767 (8th Cir. 1999) ("whether a state statute creates a contract for purposes of the Contracts Clause under the U.S. Constitution is a federal question, and as such, we are not bound by a state court's assessment of the issue, though we do accord it "'respectful consideration and great weight.'" *Picard v. Members of the Employee Retirement Board of Providence*, 275 F.3d 139, 144 (1st Cir. 2001) ("although the question whether a contract was made is a federal question, a court must "accord respectful consideration and great weight to the views of the State's highest court"); *Transport Workers Union, Local 290 v. Pennsylvania Transportation Authority*, 145 F.3d 619, 623 (3d Cir. 1998) ("Whether a contract was formed and what terms were included for purposes of the Contract Clause are federal questions.")

4. The Federal Test for Contract Impairment

In *McGrath v. Rhode Island Retirement Board etc.*, 88 F.3d 12, 16 (1st Cir. 1996), the First Circuit put together for public pension party litigants the series of tests for deciding whether the Contracts Clause has been violated, developed by the Supreme Court in other contexts.

> Over time, the Supreme Court has devised a tripartite test for use in analyzing alleged impairments of contracts. *See General Motors Corp v. Romein*, 503 U.S. 181, 186, 112 S. Ct. 1105, 117 L. Ed. 2d 328 (1992) [workers' compensation]. Under this paradigm, a court first must inquire whether a contract exists. If so, the court next must inquire whether the law in question impairs an obligation under the contract. If so, the court then must inquire whether the discerned impairment can fairly be characterized as substantial. Affirmative answers to these three queries compel a court to abrogate the proposed application of the challenged state law. See *id.*
>
> It should be noted that this tripartite test actually has a fourth component. In an appropriate case the model expands to include an inquiry as to whether the impairment, albeit substantial, is reasonable and necessary to fulfill an important public purpose. *See Energy Reserves Group v. Kansas Power & Light*, 459 U.S. 400, 411-12, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983) [state regulation of natural gas price]. If so, the challenged law will not be held to infringe rights secured by the Contracts Clause. *See id.* Furthermore, when a state is itself a party to a contract, courts must scrutinize the state's asserted purpose with an extra measure of vigilance. *See United States Trust Co. v. New Jersey*, 431 U.S. 1, 25, 97 S. Ct. 1505, 52 L. Ed. 2d 92 (1977) [repeal of covenant to subsidize bonds]. Because this fourth component requires careful judicial scrutiny in all events, it is clear that a state must do more

> than mouth the vocabulary of the public weal in order to reach safe harbor; a vaguely worded or pretextual objective, or one that reasonably may be attained without substantially impairing the contract rights of private parties, will not serve to avoid the full impact of the Contracts Clause.

For other state cases employing more careful scrutiny when the state's self-interest is at stake, see:

Christensen v. Minneapolis Municipal Employees Retirement Bd., 331 N.W.2d 740, 751 (1983) (statute reducing benefits was invalid as an unconstitutional impairment of contractual obligations to the extent that it purported to apply to elected city officials already retired at the time of its enactment). *Opinion of Justices*, 135 N.H. 625, 635, 609 A.2d 1204, 1210 (1992) (Furlough program for state employees, which would have required all state employees whose salary was greater than $ 15,000 to take unpaid days of leave, thus relieving some of the pressure on the state budget, substantially impaired the officials' vested rights that were equivalent to contractual obligations owed by the state. Consequently, the bill impaired the officials' contractual rights, just as it impaired the CBA, which in turn violated the Contracts Clauses of both the federal and state constitutions.)

The opinion in *Fund Manager [etc.] v. City of Phoenix Police [etc.] Board*, *supra*, after first holding that rights to a disability retirement only vested when the injury occurred, remanded and instructed the trial court to apply the United States Supreme Court's three-part test to determine whether the city's contract providing for disability retirement had been impaired, in violation of the Contracts Clause, when it changed the standard for full disability.

In *Jones v. Board of Trustees* (Section D.1, *infra.*), the Kentucky Supreme Court answered the first question in the positive (contract? "Yes") and the second in the negative (no harm), thus mooting the third. The Court continued in the opinion to allude to the duty of the General Assembly to oversee the budget process and all budgetary expenditures and "to take steps to insure the continued operation of government without excessive generosity to one governmental entity at the expense of others." (910 S.W.2d at 714), thus apparently paying attention to the fourth step in the analysis.

5. Federal Abstention

On the other hand, especially where there is uncertainty in the local law, federal courts have abstained from considering issues involving the rights of public retirement system participants. *See, e.g., Pineman v. Oechslin*, 637 F.2d 601, 604-606 (1st Cir. 1981), where a Connecticut contract clause claim was brought in federal court, and a federal district judge found that a contractual obligation existed and that a revision of the retirement law violated the Contract Clause. The Court of Appeals discovered that no Connecticut state court had yet ruled on the precise question — whether state employees had vested pension rights prior to becoming eligible to receive benefits — that the district court had decided, and so abstention was appropriate to afford the state courts an opportunity to adjudicate the contract law aspect of appellees' claim and recited the range of results available to a local court.

The Court of Appeals considered abstention appropriate to afford the state courts an opportunity to adjudicate the contract law aspect of appellees' claim, even though the federal courts, thereafter resolving the constitutional issue, would not be obliged to give the state court ruling the conclusive deference that abstention normally entails. Despite this lack of the usual conclusiveness of a state court determination of state law, (*see, e.g., Atlantic Coast Line Railroad Co. v. Phillips*, 332 U.S. 168, 170, 67 S. Ct. 1584, 1585, 91 L. Ed. 1977 (1947); (exemption from state income tax) abstention principles were held fully applicable; the issues in this lawsuit combined significant aspects of both the so-called Pullman and Burford branches of the abstention doctrine.

a) The state common law rule governing the vesting of public employee pension rights is highly uncertain. *See Railroad Commission of Texas v. Pullman Co.*, 312 U.S. 496, 499-501 (1940), abstaining on an undecided question about the role of the Commission's assertion of power to regulate staffing of one-Pullman sleeping car trains (a question at that time raising highly specific racial overtones with no definitive local resolution).

b) The subject matter – fixing compensation benefits to state employees – is of vital importance to the State and its governmental functioning. *See Burford v. Sun Oil Company*, 319 U.S. 315, 334 (1943); *but cf. National League of Cities v. Usery*, 426 U.S. 833, 96 S. Ct. 2465, 49 L. Ed. 2d 245 (1976), intervening to strike down a proposal to impose FLSA (Fair Labor Standards Act) overtime standards on almost all state and municipal employees.

c) State autonomy and the relationship between state and federal authority would be impaired were the federal courts to set state policy independently and follow their own instincts as to state contract law. *See Burford v. Sun Oil Co.*, *supra*, involving application for an injunction to enjoin the same Texas Railroad Commission's order authorizing drilling.

d) Considerations of comity that undergird the federal system of government make abstention appropriate.

6. State Cases Grant Varying Rights on Various Theories

a. Trend Toward Contract Theory

In 1904 New Jersey's Supreme Court found in *Ball v. Board of Trustees*, 71 N.J.L. 64, 58 A. 111 (N.J. 1904) that a legislative amendment to a teacher's retirement plan impaired a voluntary contractual relationship, basing its decision on the fact that the terms of the relationship were specified in the statute. "Contracts clause" language (emphasized below) appeared in the opinion:

> The legal relation between the plaintiff and the defendant is that of contract. By electing to accept the provisions of the act of 1896, and making or tendering the necessary payment, the plaintiff, when incapacitated, became entitled to the annuity, which, although not a personal obligation of the board of trustees, was payable to her out

> of the fund. The terms of the agreement are to be ascertained by reference to the statute. When this agreement was once made, it could not be altered without the consent of both parties thereto and upon sufficient consideration.
>
> What the act of 1899 attempted to do was to **impair the obligation of an existing contract**, and this is beyond the power of the legislature.

Increasingly state and local public employees' retirement systems and the courts have come to regard their pension benefits as part of the employment contract, a contractual or property right, and have rejected the gratuity theory as outdated. *See*, *e.g.*, *Police Pension and Relief Bd. v. Bills*, 148 Colo. 383, 366 P.2d 581, 583 (Colo. 1961) (gratuity system made pension "always subject to unilateral change of an adverse nature"; however, repeal of a so-called "escalator clause corresponding to increases in pay should not be applied either to officers who entered into government employment and thus acquired a "limited vesting" of pension rights and a "vested pension right" on retirement); *Frederick v. Quinn*, 35 Md. App. 626, 371 A.2d 724, 725-726 (Md. Spec. App. 1977) (trend is toward adopting contract theory; "a pension is more contractual than gratuitous"; "the contractual or vested rights of the employee in Maryland were subject to a reserved Legislative power to make *reasonable modifications* in the plan, or indeed to modify benefits if there is a simultaneous offsetting new benefit for liberalized qualifying conditions."); *Public Employees, Retirement Bd. v. Washoe County*, 615 P.2d 972, 974 (Nev. 1980) ("modern and better reason-view . . . an employee acquires a limited vested right to pension benefits which may not be eliminated or substantially changed by unilateral action of a governmental employer to the detriment of the member"); *Taylor v. Multnomah County Deputy Sheriff's Retirement Bd.*, 510 P.2d 339, 341 (Or. 1973) ("Oregon has joined the ranks of those rejecting the gratuity theory of pensions." Tender of contributions to retirement fund for deputy sheriffs by correction officer *held* to constitute acceptance of a unilateral offer and consideration and partial performance by her under Restatement (2d) of Contracts). *Halpin v. Nebraska State Patrolman's Retirement Sys.*, 211 Neb. 892, 320 N.W.2d 910, 913 (Neb. 1982)(Public Employees . . . have "reasonable expectations which are protected by the law of contracts without regard to their pension rights"; a prior 1944 Nebraska decision is overruled. Change of final average monthly salary for purposes of computing retirement allowance, purporting to exclude unused vacation and sick leave, *held* an unconstitutional impairment of plaintiffs' contractual rights"). *Police Pension and Relief Board, etc. v. McPhail, et al.*, 139 Colo. 330, 344, 338 P.2d 694, 701-702 (1959), affirming a trial court judgment for the retirees in their action for pension arrearages and a declaratory judgment that a city ordinance eliminating automatic increases in their pension was invalid and void, and further holding that "insofar as [*Board of Trustees v. People ex rel. Behrman*, 119 Colo. 301, 203 P.2d 490] holds that a contributory pension such as the one at bar is a gift or gratuity, even after fulfillment of conditions precedent, it is expressly overruled."

See the English Law Reform Committee Report upon Powers and Duties of Trustees, published in 1982, stating:

> the essential difference between such trusts [pension funds] and the more usual type of trusts lies in the fact that the existence of the

> trust and the benefits which it confers or is intended to confer upon the individual lies primarily in the field of contract rather than bounty.

Paragraph 57 page 49.

See also, Ky. OAG 78-4, recognizing that the enactment of the "inviolable contract" statutes "has created a contractual obligation with the members of the various retirement systems as a consequence of which the General Assembly cannot limit retirement benefits to certain maximum percentages of final annual salary as suggested in your letter."

Thus, the law in many states offers the public pension plan participant considerably greater protection than is provided to the private sector retiree. *See*, *e.g.*, *McDermott v. Regan*, 82 N.Y.2d 354, 624 N.E.2d 985, 604 N.Y.S.2d 890 (1993), holding that the legislature's attempt to change the funding method for New York State Retirement Systems from an Aggregate Cost (AC) method to a Projected Unit Credit (PUC) method violated the New York State Constitution, requiring that a system member's benefits not be "diminished or impaired." Compare P. Rehon, "The Pension Expectation as Constitutional Property," 8 Hastings Const. L.Q. 153, 162-165 (1980), setting forth the Supreme Court's doctrine that "allows state legislatures and Congress to define the scope and nature of property under the due process clauses of the Fifth and Fourteenth Amendments" and describing how the expectation of private pensioners often does not achieve a definition of constitutionally recognized "property."

A body of court decision law has developed defining what these rights are in the absence of (or interpreting) constitutional and statutory provisions. Some courts find that pension legislation creates unilateral contracts, while others conclude that interests in receiving benefits are property rights or rely on a theory of "promissory estoppel" to protect the public employee from unreasonable changes in his/her pension expectations. Promissory estoppel is "a promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee . . . and [that] does induce such action or forbearance is binding if injustice can be avoided only by the enforcement of the promise." Restatement (Second) of Contracts § 90 (1981). Enforcement of due process in protecting property rights against the government may be more uncertain of success than enforcement of contract rights; Note, "Public Employee Pensions in Times of Fiscal Distress," 90 Harvard L.Rev. 992, 1002-3 (1977), analyzing the various theories of entitlement.

b. Constitutional Provisions

Of the states that use some form of a contract theory to enforce the rights of public employees to their pensions, the rationales for a contractual approach are not all the same. Six states have provisions in their state constitutions guaranteeing that an employee's right to a pension "vests" at the time of employment and that the state legislature may not substantially alter those rights thereafter. The state constitutions of Alaska, Hawaii, and Michigan all have provisions protecting those pension benefits which the employee has already accrued. Alaska Const. Art. XII, § 7; Hawaii Const. Art. XVI, § 2; Michigan Const. Art. IX, § 24. Their state courts, however, have allowed legislative modification of conditions for future benefits. *See*,

e.g., *Hammond v. Hoffbeck*, 627 P.2d 1052, 1057 (Alaska 1981); *Chun v. Employees' Retirement Sys.*, 607 P.2d 415, 422 (Haw. 1980).

Illinois and New York have constitutional amendments that protect employees' rights to retirement benefits from legislative diminution after hiring. Ill. Const. Art. XIII, § 5

> SECTION 5. Pension and Retirement Rights
>
> Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

N.Y. Const. Art. V, § 7. *Kraus v. Board of Trustees of Police Pension Fund*, 390 N.E.2d 1281, 1292 (Ill. App. 1979) and *McDermott v. Regan.*, *supra* (employees' rights to benefits fixed once they enter the system.)

c. Strict Contract Theory

States that guarantee a contractual right absent a specific state constitutional provision fall into three categories. First, are those states that follow a "strict contract" theory under which all elements of the contract vest upon employment and are not subject to future change without consent of the employee. This approach has been adopted in several states. *Burks v. Board of Trustees*, 104 S.E.2d 225, 227 (Ga. 1958) (a pension is a contract and cannot be modified or repealed by legislation); *Association of Pa. State College & Univ. Faculties v. State Sys. Of Higher Educ.*, 505 Pa. 369, 479 A.2d 962, 966 (Pa. 1984) (prohibiting unilateral reduction of retirement benefits by legislature); *Yeazell v. Copins*, 98 Ariz. 109, 402 P.2d 541, 545 (Ariz. 1965) (legislature could neither alter the provisions of membership in a pension fund nor reduce the amount of the contributions to the fund, even if the soundness of the fund was in jeopardy). But cf. *Fund Manager, Public Safety Personnel Retirement System v. City of Phoenix Police Department Public Safety Personnel Retirement System Board*, 151 Ariz. 487, 490, 728 P.2d 1237 (1986), quoting the *Yeazell* opinion as not prohibiting the state from prospectively changing "'future benefits as yet unvested'" and remanding to a trial court to determine whether and under what circumstances the state can change the standards under which a disability pension might be granted.

d. "Modified" Contract Theory

Second, a "modified contract" approach, followed by the California Supreme Court, permits legislative changes to public employee pensions only if it offers comparable new advantages to accrue to the pension to offset any detriment. The contractual right has existed in California since *O'Dea v. Cook*, 176 Cal. 659, 169 Pac. 366 (1917):

> a pension is a gratuity only where it is granted for services previously rendered which at the time they were rendered gave rise to no legal obligation. [Citations.] But where, as here, services are rendered under such a pension statute, the pension provisions

> become a part of the contemplated compensation for those services and so in a sense a part of the contract of employment itself.

In those jurisdictions, an employee's pension benefits are vested on the date of hire; any changes that result in a disadvantage to members must be accompanied by comparable new advantages, and the advantageous offset must relate generally to the diminished benefit and to the theory of a pension plan. *See, e.g., Allen v. City of Long Beach*, 45 Cal.2d 128, 131, 287 P.2d 765, 767 (1955) (rejecting various increases in employee contribution rates and computation of retirement benefits as reducing "vested contractual pension rights"):

> To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. [Citations.] In the present case it appears that section 187.2 substantially decreases plaintiffs' pension rights without offering any commensurate advantages, and there is no evidence or claim that the changes enacted bear any material relation to the integrity or successful operation of the pension system established by section 187 of the charter.

Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981) (quoting *Allen*):

> If the plan sponsor wishes to decrease pension benefits, it can only do so for employees hired in the future, either by the creation of new "tiers" in the same plan, with diminished benefits and lower costs, or by creating or transferring into a different public retirement system if one is available.

That principle is more recently enunciated in a state-wide context in *Betts v. Board of Administration*, 21 Cal.3d 859, 863-864, 582 P.2d 614, 148 Cal. Rptr. 158 (1978).

The California position is substantially adopted by state courts in a number of other states. *See Police Pension* and *Relief Bd. of Denver v. Bills*, 148 Colo. 383, 366 P.2d 581, 585 (1962); *Nash v. Boise City Fire Dept.* 104 Idaho 803, 663 P.2d 1105, 1108-10 (1983); *Brazelton v. Kansas Public Employees Retirement Sys.*, 227 Kan. 443, 607 P.2d 510, 517-18 (1980); *Opinion of the Justices*, 364 Mass. 847, 303 N.E.2d 320, 328 (Mass. 1973); *Eisenbacher v. City of Tacoma*, 53 Wash.2d 280, 333 P.2d 642, 645 (Wash. 1958).

These rights may also be asserted under the federal civil rights law (42 U.S.C. § 1983). *See McDaniel v. Board of Education*, 44 Cal.App.4th 1618, 52 Cal.Rptr.2d 448 (1996) (complaining about defendant school district's retaliatory denial of early retirement.) *Accord, Thorning v. Hollister School District*, 11 Cal.App.4th 1598, 15 Cal.Rptr.2d 91 (1992) (discontinuance of health benefit payments).

e. Limited Protection—of Benefits Only, Not Funding

A third approach recognizes a contract "that protects only the right to receive benefits," but does not protect the method of funding. *McNamee v. State*, 173 Ill.2d 433, 445 446, 672 N.E.2d 1159, 1165-1166 (1996), analyzing the transcripts of the Illinois constitutional proceedings to show that the quoted constitutional provision only protects pension benefits and does not require any particular method of funding and distinguishing on that account *McDermott v. Regan*, *supra* (New York constitution protects against change of funding method as an impairment of benefit) on grounds that the Illinois constitutional provision was narrower in scope.

There is a noticeable similarity between that decision and the decision in the Kentucky *Jones* case, where the attack upon the effect on funding of a reduced employer contribution was disregarded in view of the plaintiffs' failure to demonstrate that payments of benefits "have been or will be infringed." See 910 S.W.2d 710, 713.

f. Limitation on Protection and Vesting

In states that have adopted a contract or modified contract body of law, courts and governing bodies have nevertheless announced correlative rules that on occasion may limit the extent to which beneficiaries can claim that their contract with the government had been unconstitutionally impaired.

- In some cases, it has been found that the agreement or statute before the court created no contract. (*E.g.*, *Spiller v. State*, 627 A.2d 513, 516 (Me. 1993) (statute); *Castellano v. City of New York*, 142 F.3d 58, 73 (2d Cir. 1998) (collective bargaining agreement) Where there is no contractual relationship, however, there can be no impairment. See *General Motors Corp. v. Romein*, 503 U.S. 181, 186, 117 L. Ed. 2d 328, 112 S. Ct. 1105 (1992) ("This court has previously rejected a Contract Clause claim brought by police retirees based upon the same CBA, holding that the CBA plainly did not create any contractual obligation, . . . ").

- Even though a contract exists, the particular feature of the retirement system may be considered not one covered by the contract and therefore not impaired. (*E.g.*, *Colorado Springs Fire Fighters Ass'n, Local 5 v. City of Colorado Springs*, 784 P.2d 766, 770-73 (Colo. 1989) ("health benefits" not included in statutory term "pension benefits");

- The impairment has been offset by comparable advantages. (*E.g.*, *Peterson v. Fire and Police Pension Assoc.*, 759 P.2d 720 (Colo. 1988) (Court finds General Assembly's modification of survivor benefits was proper because "the financial loss experienced by the petitioners is offset by the creation of a fund that will ensure that the petitioners' future benefits are funded by a stable and actuarially sound pension fund.").)

- The exigencies facing the government are such as to take precedence over the contractual obligations of the pension plan. (*E.g., Louisiana State Troopers Assoc. v. Louisiana State Police Retirement Board*, 417 So. 2d 440 (La. App. 1975) (Court holds, "We believe that the acts of the legislature in the instant case withdrawing entitlement to the purchase service credits for prior employment and increasing the percentage of payment required to purchase credits are legitimate acts for improving the actuarial integrity of the System and are not unconstitutional.").)

- Provisions of the retirement plan may impose conditions precedent to vesting, or the plan itself may delay the time at which entitlement "vests." (*E.g., Fund Manager, Public Safety Personnel Retirement System v. City of Phoenix Police Department Public Safety Personnel Retirement System Board*, 151 Ariz. 487, 728 P.2d 1237 (1986).)

- That time may vary between as early as the moment of employment to a later date after a particular term of service or only upon actual retirement. See *McGrath v. Rhode Island Retirement Board, Etc*., 88 F.3d 12, 17 (1996), holding that a legislated change to a substantive provision of a public employees' retirement plan did not violate the Contracts Clause of the United States Constitution, where employee's pension rights had not yet vested when the modification occurred, and the state had "explicitly" reserved the power to alter or revoke its promise of retirement benefits to municipal employees at the time it established the plan in which McGrath later became a participant. As illustrated in that decision, There is significant disagreement about when contractually enforceable rights accrue under such plans. *See, e.g., Nevada Employees Ass'n, Inc. v. Keating*, 903 F.2d 1223, 1227 (9th Cir.) (suggesting that nonvested employees have contractual rights subject only to "reasonable modification"), cert. denied, 498 U.S. 999, 111 S. Ct. 558, 112 L. Ed. 2d 565 (1990); *Betts v. Board of Admin. of the Pub. Employees' Ret. Sys.*, 21 Cal. 3d 859, 582 P.2d 614, 617, 148 Cal. Rptr. 158 (Cal. 1978) (stating that the right to a "substantial or reasonable" pension accrues on first day of employment); *Petras v. State Bd. of Pension Trustees*, 464 A.2d 894, 896 (Del. 1983) (explaining that rights accrue when vesting occurs); *Singer v. City of Topeka*, 227 Kan. 356, 607 P.2d 467, 475 (Kan. 1980) (similar to *Petras*, but adding that rights remain subject to "'reasonable modifications'"); *Sylvestre v. State*, 298 Minn. 142, 214 N.W.2d 658, 666-67 (Minn. 1973) (taking the position that an employee's rights accrue on first day of employment); *Baker v. Oklahoma Firefighters Pension & Ret. Sys.*, 718 P.2d 348, 353 (Okla. 1986) (holding that rights accrue only when an employee vests); *Leonard v. City of Seattle*, 81 Wash. 2d 479, 503 P.2d 741, 746 (Wash. 1972) (en banc) (similar to Baker).

- Some states hold that there are no rights under a pension plan until the state employee satisfies all the eligibility requirements, including age and years of service, for receiving benefits. *See, e.g., Etherton v. Wyatt*, 155 Ind.App. 440, 293 N.E.2d 43 (Ct.App.1973); *McFeely v. Pension Comm'n*, 8 N.J.Super. 575, 73 A.2d 757 (Law Div.1950); *Creps v. Board of Firemen's Relief & Retirement Fund Trustees*, 456 S.W.2d 434 (Tex.Civ.App.1970).

- Others hold that pension rights vest unconditionally upon employment. *See, e.g., Yeazell v. Copins*, 98 Ariz. 109, 402 P.2d 541 (1965); *Betts v. Board of Administration*, 21 Cal.3d 859, 863-864 (1978) ("a vested contractual right to pension benefits accrues upon

acceptance of employment"); Cf. N.Y.Const. Art. V, § 7 ("After July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired.").

- Still others apply a limited vesting concept, holding that pension rights vest upon employment subject to "reasonable" modification by the public employer. *See, e.g., Allen v. City of Long Beach*, quoted at page 18, *supra.*; *Police Pension Relief Bd. v. Bills*, 148 Colo. 383, 366 P.2d 581 (1961); *City of Frederick v. Quinn*, 35 Md.App. 626, 371 A.2d 724 (Ct.Spec.App.1977).

In *Police Pension & Relief Board of City and County of Denver v. Bills*, 148 Colo. 383, 366 P.2d 581, 584 (Colo. 1961), where the court recognized a "*limited* vesting of his pension rights while still in active employment and a *vested* pension right upon retirement. The same result obtains when during his active governmental employment a particular pension plan is placed in effect, the theory being that such is a material inducement to the employees to remain in the employment of the government. [Citations] On that basis the court held that "not only prior to their actual retirement, but also prior even to their eligibility to retire, there was a limited vesting in these plaintiffs of their pension rights to the end that although prior to their eligibility to retire, the pension plan could be changed, it could not be abolished nor could there be a substantial change of an adverse nature, without a corresponding change of a beneficial nature."

In *Fund Manager [etc.] v. City of Phoenix Police Department*, 151 Ariz. 487, 728 P.2d 1237 (1996), vesting when considered in the context of a right to a disability pension as distinguished from a retirement due to age, was determined to occur only "upon the occurrence of the event or condition which would qualify him for such pension — the injury." (The case was remanded to apply the three steps required by the Supreme Court's analysis, Section B.4, *supra*, and inasmuch as the retirement system was administered by the state, complete deference to its assessment "is not appropriate.")

Where the prospect of change is built into the statutory scheme, such changes are pre-authorized, and there is no vested right to an unchanging benefit. *International Ass'n of Firefighters v. City of San Diego*, 34 Cal.3d 292 (1983) (increases in employee contribution rates authorized by the terms of the existing actuarially-based system); *Pasadena Police Officers Ass'n v. City of Pasadena*, 147 Cal.App.3d 695, 711 (1983) (increase in employee contribution rate as a result of actuarial adjustments in accordance with pre-existing authority did not violate employees' vested rights).

These authorities only emphasize further the need to consider the specific statutory language that both creates the claimed contractual right and the possible reservation of the right of change.

Two states have rejected both contract and gratuity theories to determine the constitutionality of a public pension modification in favor of other legal doctrines, promissory estoppel and due process, discussed below.

g. Promissory Estoppel.

Minnesota utilized the doctrine of promissory estoppel, *see Christensen v Minneapolis Municipal Employees Retirement Board*, 331 N.W.2d 740, 748-749 (Minn. 1983) (holding that the protectable right of a public employee to an offered pension is determined by applying promissory estoppe1); *Law Enforcement Labor Services, Inc. v. County of Mower*, 483 N.W.2d 696, 701 (Minn. 1992) (health premium subsidies vested for life because retiree had reasonably relied upon written assurances that had been made at the time he retired and followed thereafter for some years, although the collective bargaining agreement did not contain express provision for the payment of health care insurance premiums; *Christensen, supra*, followed and vested rights *held* created by estoppel); *Senior Citizens Coalition v. Minnesota Pub. Utils*., 355 N.W.2d 295, 304 (Minn. 1984) (holding that the protectable right of a public employee to an offered pension is determined by applying promissory estoppe1).

Cf. *Axelson v. Minneapolis Teachers' Retirement Fund Ass'n*, 544 N.W.2d 297, 299-300 (1996):

> *Axelson*'s claim to the retirement service credits is based on the doctrine of promissory estoppel . . . [citing *Christensen*.] This court has held, however, that "'where an agency has no authority to act, agency action cannot be made effective by estoppel.'" *See also Spaulding v. Board of County Comm'rs*, 306 Minn. 512, 515, 238 N.W.2d 602, 604 (1976) (county cannot be bound by estoppel to make unauthorized payments to county officer where sick leave policy covers only county employees); *Board of Educ. v. Sand*, 227 Minn. 202, 211, 34 N.W.2d 689, 695 (1948) ("estoppel cannot be invoked to confer upon a political subdivision of the state governmental power otherwise lacking").

For other cases unsuccessfully basing members' claims on promissory estoppel see:

Duluth Firemen's Relief Ass'n v. Duluth, 361 N.W.2d 381 (1985) (rejecting claim based upon promissory estoppel theory); *AFSCME Council 6 v. Sundquist*, 338 N.W.2d 560 (1983) (similar); *Minneapolis Teachers Retirement Fund Ass'n v. State*, 490 N.W.2d 124 (1992); *Simpson v. North Carolina Local Government Employees' Retirement System*, 88 N.C. App. 218, 363 S.E.2d 90 (1987).

Promissory estoppel, based on the factual circumstance of reliance, may be more uncertain of application than a contract applicable to all pensions and all pensioners.

h. Due Process.

Connecticut adopted a due process approach to protect public employees from arbitrary legislative confiscation of retirement funds or forfeiture of benefits, but not from any pension statute change with a negative impact. *Pineman v. Oechslin*, 488 A.2d 803 (Conn. 1985), rejecting any claim of contractual right. (In an earlier case asserting the same claim in federal court, a federal district judge found that a contractual obligation existed and that revision of the retirement law violated the Contracts Clause. The Court of Appeals for the First Circuit had

earlier discovered that no Connecticut state court had then ruled on the precise question — whether state employees enjoyed vested pension rights prior to becoming eligible to receive benefits — that the district court had decided in favor of vesting, and so abstention was appropriate to afford the state courts an opportunity to adjudicate the contract law aspect of appellees' claim. State autonomy and the relationship between state and federal authority would be impaired were the federal courts to set state policy independently. *Pineman v. Oechslin*, 637 F.2d 601 (1st Cir. 1981). Abstention thus changed the ultimate ruling.)

In *Miller v. Retirement Board of Policemen's Annuity and Benefit Fund*, 329 Ill.App.3d 589, 771 N.E.2d 431 (Ill. App. 2001), a class action involving a post-employment amendment to the pension law that reduced benefits to certain police officers, it was held that the application of that statute deprived the officers of a constitutionally protected property interest in their pension benefits without due process of law in violation of 42 U.S.C. § 1983 (a civil rights action). The suit was based upon the Pension Protection Clause of the Illinois Constitution of 1970 (article XII, § 5), which provides: "Membership in any pension or retirement system of the state [etc.] shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." In this case the application of the amending statute directly diminished the plaintiffs' benefits under the contract.

The opinion found a further violation of due process because the statute gave the board power to increase or reduce or suspend an annuity that had been fixed "as the result of misrepresentation, fraud or error; provided the annuitant . . . concerned shall be notified and given an opportunity to be heard concerning such proposed action." The lack of any predeprivation hearing unconstitutionally violated due process.

The case is of interest principally because it illustrates another vehicle for challenging the constitutionality of retroactive changes in pension law — lack of procedural due process (no notice or hearing). We have discovered no similar notice statute in the Kentucky retirement statutes.

7. Medical Benefits

Whether medical insurance and other benefits are part of the retirement benefit conferred by public retirement systems is a matter upon which jurisdictions differ, with the difference depending substantially on the local statutes and on the local courts' approach to statutory construction.

a. Included in Retirement Benefits

Some jurisdictions, hold that medical benefits are part of the retirement benefit package. *Duncan v. Retired Public Employees of Alaska, Inc.*, 71 P.3d 882 (Alaska 2003) ("accrued benefits" in the Alaska Constitution "includes all retirement benefits that make up the retirement benefit package that becomes part of the contract of employment when the public employee is hired, including health insurance benefits" and not limited to the dollar contribution in force at the time of … retirement or purchase.)

Accord, Thorning v. Hollister Sch. Dist., 11 Cal. App. 4th 1598, 15 Cal. Rptr. 2d 91, 95 (Cal.App. 1992) (holding that health and life insurance post-retirement benefits were not a

gratuity, were "fundamental" benefits because they were part of district policy and important as inducement for continued service and as factor in decision to retire and could not therefore be unilaterally terminated); *Weiner v. County of Essex*, 262 N.J. Super. 270, 620 A.2d 1071, 1079-80 (N.J. Super. Law Div. 1992) (finding that post-retirement medical benefits were property rights of employees employed at the time, and thus the county could not unilaterally terminate them without "reasonable notice [and] opportunity to be heard"); *Emerling v. Village of Hamburg*, 255 A.D.2d 960, 680 N.Y.S.2d 37, 37-38 (N.Y. App. Div. 1998) (holding that absent express reservation of rights, city could not eliminate retiree medical benefits promised in return for ten years of employment where Village rules provided "coverage will be maintained until … death"); *McMinn v. City of Oklahoma City*, 1997 OK 154, 952 P.2d 517, 521-22 (Okla. 1997) (holding that "retirement benefits" included package of pension, medical, and other benefits rather than pension benefits alone); *State ex rel. City of Wheeling Retirees Ass'n, Inc. v. City of Wheeling*, 185 W. Va. 380, 407 S.E.2d 384, 387 (W. Va. 1991) (construing statute to require same medical insurance benefit level "at the same cost for the same coverage" for retirees as for employees); *Law Enforcement Labor Services, Inc. v. County of Mower*, 483 N.W.2d 696, 701 (Minn. 1992) (health premium subsidies vested for life because retiree had reasonably relied upon written assurances that had been made at the time he retired and followed thereafter for some years, although the collective bargaining agreement did not contain express provision for the payment of health care insurance premiums; *Christensen, supra*, followed and vested rights *held* created by estoppel); *McClead v. Pima County*, 174 Ariz. 348, 358-359, 849 P.2d 1378 (Ct. App. 1992) (rejecting taxpayer suit challenges to various post-retirement benefit increases as (inter alia) unconstitutional gifts or extra compensation after services have been rendered, noting that each type of benefit functioned to augment employees' deferred compensation and making no distinction between pension increases and health insurance premium subsidies).

b. Separate From Retirement Benefits

Other states have concluded that particular language conferring health benefits did not create a vested contractual pension right. *See, e.g., Colorado Springs Fire Fighters Ass'n, Local 5 v. City of Colorado Springs*, 784 P.2d 766, 770-73 (Colo. 1989) (denying vested contractual or "pension type benefit" status to health premium subsidies where, inter alia, city ordinance contained no words of contract, did not require the consent of city employees to become effective, and was amended within six months of its passage; city ordinance providing "health plan benefits" for retired city employees are not "pension benefits," subject to vesting and to state and federal constitutional Contracts Clauses, relying on ERISA vesting distinctions between health insurance (a non-vested welfare benefit) and vested pension benefits); *Musselman v. Governor*, 448 Mich. 503, 533 N.W.2d 237 (1995), on rehearing, 450 Mich. 574, 545 N.W.2d 346, 347-48 (1996) (a maze of separate opinions arising from attempts to fund health care benefits when the full cost of retirement for school employees was shifted from state to local school districts; the opinions either refused to include health care benefits within "financial benefits" or refused to deal with the interpretation issue); *Davis v. Wilson County*, 70 S.W. 3d 724, 727-28 (Tenn. 2002) (holding that health care benefits did not vest and could be terminated absent clear intent for them to vest).

National Ass'n of Gov't Employees v. Commonwealth, 419 Mass. 448, 452-454, 646 N.E.2d 106-109 (1995) (reduction in subsidies for employee health premiums from 90 to 85% upheld against claim of unconstitutional contract impairment where the legislature had reserved

to itself the power to change the percentage of the Commonwealth's agreed contributions, which had varied over the years in accordance with various appropriation statutes); *Lippman v. Bd. of Educ. of the Sewanhaka Central High School Dist.*, 66 N.Y.2d 313, 487 N.E.2d 897 (1985) (health benefits plan under the Civil Services Law and requiring participating employer to pay at least 50% of the premium (and 35% for dependants) with provision for employer to elect to pay higher rates of contribution, *held* outside state's special constitutional provision protecting retirement benefits from diminution or impairment; The consequence that the retiree's check will be diminished by the increased financial burden on him or her is "no more a change in retirement benefits than would be an increase in the price of eggs at the supermarket or in a retiree's apartment rent.").

Most recently in a case by public school retirees against their retirement system and its board, the Michigan Supreme court has held that health care benefits were not a contractual right subject to the prohibition against impairment of contracts, and therefore could be changed by such diminutions as increases in co-pay and increase in deductibles. *Studier et al. vs. Mich Pub School Employees' Retirement Board et al.*, 472 Mich 642, 698 N.W.2d 350 (2005), affirming 260 Mich. App. 460, 679 N.W.2d 88 (2004). The Court of Appeals had determined that the statutory benefits conferred had established a contract but that the subsequent legislative changes were insubstantial and thus created no constitutionally impermissible impairment of contract. The Supreme Court held that no contract had been created and affirmed on that ground, engaging in detailed analysis of the State constitutional provision, the convention that adopted it, and holding that health care benefits did not qualify as "accrued" benefits or "financial" benefits as understood when the state constitution was ratified. It held that no contractual right had been accrued in favor of the employees by a statute, inasmuch as "A fundamental principle of the jurisprudence of both the United States and this state is that one legislature cannot bind the power of a successive legislature." One concurrence on grounds that healthcare benefits could not have been embraced in a constitution ratified when "healthcare benefits did not exist at that time." Two justices dissented, arguing for the character of healthcare benefits as "accrued financial benefits" protected by the state constitution from diminution, and that the statutory provision for retirement healthcare benefits created a contract.

8. Funding and Contribution Levels

The funding ratios of state and local public retirement plans show that they are generally in reasonable financial health. The value of the assets as a percentage of the actuarial accrued liability averaged 88.7%, amortizing the remaining liabilities over 23 years. The Public Pension Coordinating Council (PPCC), 1997, Survey of State and Local Government Employee Retirement Systems (1997). The survey covers 261 systems, representing 379 retirement plans. These plans cover 81% of 13.6 million active plan members reported by the United States Bureau of the Census and held 81% of the $1.6 trillion in retirement system assets reported by the Federal Reserve. The PPCC's survey covers a major portion of the state and local government pension plans.

In some states, underfunding is still occurring and manifests itself in two principal ways: First, the legislature and executive fail to make the full contribution needed to adequately fund the retirement system. Second, they try to change the actuarial assumptions or the funding

method used to calculate the amount of the contribution. *See, e.g., McDermott v. Regan*, note, 4, *supra*, rejecting such an effort.

The California legislature's delay in making the state's contributions to the Public Employees Retirement System (PERS) unconstitutionally impaired PERS members' contractual right to an actuarially sound retirement system. *Board of Administration v. Wilson*, 52 Cal.App.4th 1109, 1137, 61 Cal.Rptr.2d 207 (1997).

In New York, the conversion of a COLA (cost of living adjustment) reserve fund to replace future employer contributions was held to violate the state constitutional protection against the diminution or impairment of public employees' pension benefits, *McCall v. State of New York*, 219 A.D.2d 136, 640 N.Y.S.2d 347 (1996), whereas essentially the same sort of legislative action was approved in California because the trustees had earlier determined that the system was actuarially sound without regard to a similar COLA fund. *Claypool v. Wilson*, 4 Cal.App.4th 646, 671-672, 6 Cal.Rptr.2d 77 (1992).

In *Dadisman I*, the Governor decided not to include in his annual budget the full amount of employer contributions, as determined by the retirement fund trustees' actuary. 181 W. Va. at 785-786. The West Virginia court rejected the Governor's argument that "this underfunding constitutes merely a technical, rather than substantial, impairment of the State's contract with its public employees." *Id*. at 790. In finding that the Governor's actions substantially impaired the public employees' contract rights, the court followed *Valdes* and cases from other states that hold "that even where a unilateral reduction in the state's share of pension contributions, as earned by State employees, does not result in out-of-pocket losses for plan participants, they still have a vested interest in the integrity and security of the funds available to pay future benefits." *Dadisman I*, 181 W. Va. at 790-791. The *Dadisman I* court noted that the Legislature had not "articulated any public purpose for the underfunding" and there was no evidence that it "serve[d] to keep the pension system sound and flexible or [was] offset by comparable new advantages to the participants." *Id*. at 791.

In a later decision, *State ex rel. Dadisman v. Caperton*, 186 W. Va. 627, 413 S.E.2d 684 (W. Va. 1991) ("*Dadisman II*"), the court held that the state was not required to repay the amount of the prior underfunding because there was no showing that the pension fund had thereby been "rendered actuarially unsound." Although it did not order repayment, the *Dadisman II* court stated that its opinion was "hinged upon the assumption that there will continue to be timely and complete funding and proper application of all employer contributions to the employer accumulation fund of the PERS, without diversion to unauthorized purposes." *Dadisman II*, 186 W. Va. at 632.

The implication of the court's assumption is that an escalation of underfunding would invite a finding that the underfunding had rendered the fund actuarially unsound and therefore violative of the contract.

Courts in other states have also held that legislation or other actions that appeared to threaten the security of funds available to pay future retirement benefits were a substantial impairment of the contractual pension rights of public employees. For example, in *McDermott v. Regan*, 587 N.Y.S. 2d 533 (1992), *aff'd*, 599 N.Y.S. 2d 718 (1993), the New York Legislature

enacted a law that required the retirement system trustee to use the projected unit credit (PUC) method, rather than the aggregate cost (AC) method, as the actuarial funding method to determine public employers' annual contributions. The change from the AC to PUC method was designed to reduce those contributions. *McDermott*, 587 N.Y.S. 2d at 140. The court held that this law violated the contractual relationship "providing that [public employees'] pensions would be funded and secure." *Id*. at 141. The court stated that "[o]ne of the contract benefits public employees acquired as a result of the constitutional amendment was the right to an independent trustee imbued with discretion to protect their investment funds." *Id*. at 142. The court held that, by mandating that the trustee use the PUC method, the legislation at issue was "an unconstitutional attempt to divest public employees of that contract right" and "would divert the accumulated pension funds of public employees to meet a present fiscal crisis by reducing the contributions of public employers in order to avoid raising taxes and cutting other programs." *Id*.

The implication of the language just quoted is that a claim of financial shortage would not be sufficient to overcome the burden of establishing that the change of funding method had not been justified under the standards imposed by the Supreme Court.

In *Dombrowski v. Philadelphia*, 431 Pa. 199, 245 A.2d 238 (1968), the Pennsylvania Supreme Court affirmed the lower court's ruling that the City of Philadelphia's contributions to its retirement system "were insufficient to maintain its retirement system on an actuarially sound footing," in violation of the city's Home Rule Charter. *Dombrowski*, 431 Pa. at 201. The Court held that the plaintiff, a city employee entitled to receive pension benefits, was "suffering a present impairment of his contractual rights and thus an immediate injury" because the evidence showed that the city's "practices had placed the system on an actuarially unsound basis, and if continued, the unsoundness would progressively increase." *Id*. at 214-215. In a footnote, the Court stated, "actuarial soundness requires that the municipality contribute a sum of money **each year** sufficient to cover the 'normal cost' for that year plus interest on the system's 'unfunded accrued liability.'" *Id*. at 201-202 n.1 (emphasis added).

The implication of Pennsylvania's requirement of annual contributions and concern about progressive increase of actuarial unsoundness may either be construed as a stricter standard than that imposed by the *Jones* opinion, or only a more extreme violation of actuarial soundness than *Jones* found, inasmuch as the *Jones* court had before it affidavits of actuaries indicating (or at least arguing) that the modification of measuring tools was only a recognition of relevant facts rather than a deprivation of benefits, or even of actuarial soundness.

In *Weaver v. Evans*, 80 Wn.2d 461, 495 P.2d 639 (1972), the Washington Supreme Court held that the Governor had violated public employees' contractual rights when he decided not to transfer to the retirement system all of the funds that the Legislature had appropriated for that purpose. The Court stated that the Legislature's adoption of a "systematic method" of funding to achieve "actuarial soundness of the retirement system," was "one of the vested contractual pension rights flowing to members of the system," and that "such a vested contractual right cannot be unilaterally modified except for the purpose of keeping the retirement system flexible and maintaining its integrity, which modification in turn must be reasonable and bear some material relation to the theory of a pension system and its successful operation, else the vested contractual right becomes unconstitutionally impaired." *Weaver*, 80 Wn.2d at 478.

In *Retired Public Employees Council v. Charles*, 148 Wn.2d 602, 62 P.3d 470 (Wash. 2003), the Washington Supreme Court followed *Weaver* in finding that public employees "have vested contractual rights to the systematic funding of the retirement system to maintain actuarial soundness." *Charles*, 148 Wn.2d at 625. The Court in *Charles*, however, held that those rights were not substantially impaired by legislation that lowered the rate of employer contributions. *Id*. at 626-627. The Court stated that the plaintiffs had not shown that "the lower contribution rates prevent the successful operation of the pension system." There was "no showing of how much the lower contribution rates would lessen the value of the retirement system, if at all" and "no indication that the lowered contribution rates render the system actuarially unsound." *Id*. at 627.

In *Kosa v. State Treasurer*, 408 Mich. 356, 292 N.W.2d 452 (Mich.1980), the Michigan Supreme Court held that a change in the method of funding the retirement system did not infringe the public employees' contractual rights. The Court stated, "A clear distinction must be drawn between the right to receive pension benefits and the funding method adopted by the Legislature to assure that monies are available for the payment of such benefits." *Kosa*, 408 Mich. at 371. There was no violation of contractual rights because "the right of public employees to receive pension payments as those payments become due has been fully met" and, even if the employees' contractual rights also covered methods of funding, "the former 'attained age' and present 'entry age normal' methods of funding are generally accepted and actuarially sound, and provide equivalent reserves for payment of pension benefits." *Id*. at 372. As pointed out in the subsequent decision in 2003, there was apparently, as in *Jones*, a burden upon the plaintiffs to show a danger to the actuarial soundness of the system. The *Kosa* case, like *Jones*, and unlike others, such as McDermott, would leave the choice of funding to those responsible for the funding as distinguished from those who administer the funds.

In *Claypool v. Wilson*, 4 Cal.App.4th 646 (1992), the California Court of Appeal held that the use of funds from former supplemental cost of living adjustment programs to offset employer contributions did not impair the employees' funding rights. The court found there was no impairment because the funds at issue "were not previously counted toward actuarial soundness of PERS, were not reserved to underwrite the actuarial soundness of the basic pension benefits, and are not now tied to the provision of any special benefits required to be paid." *Claypool*, 4 Cal.App.4th at 671.

Later, however, in *Board of Administration v. Wilson*, 52 Cal.App.4th 1109 (1997), the California Court of Appeal held that legislation changing the schedule for the state to pay employer contributions to the retirement fund to "annually, 12 months in arrears" was an unconstitutional impairment of the employees' contract rights because the legislation consisted of "budget balancing measures," there was no showing of "any pension reform or pension-related connection whatsoever," the legislation "afforded no comparable advantage" to the employees whose contract rights were modified, and the impairment was substantial. *Board of Administration*, 52 Cal.App.4th at 1138, 1153. The court stated that "state employees have a contractual right to an actuarially sound retirement system." *Id*. at 1131. The court found that there was substantial evidence that the delay in funding rendered the retirement fund actuarially unsound. *Id*. at 1139.

The variation between earlier and later cases proves that it is in practice necessary, even in jurisdictions where the vesting of pension benefit interests is enthusiastically enforced, for the enforcers to demonstrate the harm, current or future, in order to invalidate efforts to modify the retirement system, the method of funding, or the timing of payment.